WORKING CAPITAL FINANCING IN THE NEW ECONOMY:

Current Legal Issues and the Need for Federal Legislative Reforms

A REPORT BY
THE UNIFORM COMMERCIAL CODE COMMITTEE
BUSINESS LAW SECTION
STATE BAR OF CALIFORNIA

Suzanne L. Weakley Anthony R. Callobre Julie B. Landau James D. Prendergast

WORKING CAPITAL FINANCING IN THE NEW ECONOMY:

Current Legal Issues and the Need for Federal Legislative Reforms

A REPORT BY
THE UNIFORM COMMERCIAL CODE COMMITTEE
BUSINESS LAW SECTION, STATE BAR OF CALIFORNIA
June 2001

Executive Summary

Working capital loans are often secured by personal property of the business receiving the loan proceeds. The amount that a business will be eligible to borrow will depend on the value of the assets securing the loan, as well as the lender's assessment of the legal and economic risks associated with the borrowing. The most valuable assets to a lender are liquid assets such as accounts receivable and inventory, which are readily convertible to cash. For manufacturing companies, accounts receivable may include receivables from the sale or lease of manufactured products incorporating patented technology or trade secrets. For software companies, accounts receivable typically include receivables from the licensing of software, the source and object codes of which may or may not be copyrighted and are usually confidential. For companies in the entertainment and publishing industries, accounts receivable include receivables from the sale or rental of copies of copyrighted works.

In secured working capital financings, the maximum loan amount will be based on the value of that part of the borrower's personal property in which the lender can obtain a fully enforceable security interest. Uncertainties in the legal status of the lender's rights in the collateral may adversely impact the loan transaction by reducing the available collateral, and accordingly, the maximum loan amount. Legal uncertainties increase the economic risk of the loan facility to the lender, and therefore also may be reflected as increases in the interest rate. In addition, legal uncertainties will increase transaction costs paid by the borrower, because the lender will take extra precautions and incur additional expenses in an effort to mitigate the risks.

At present, financings based on intellectual property or derivative intellectual property rights such as royalties from licensing are fraught with legal uncertainties. These uncertainties are the product of various conflicts and inconsistencies in the federal and state laws governing intellectual property secured transactions. Applicable laws include the federal patent, copyright and trademark statutes, which govern registration and ownership rights in intellectual property, and Article 9 of the Uniform Commercial Code ("UCC"), which governs personal property-secured loan transactions. These laws were adopted at different times over the last 50 years, and are not integrated with one another. The conflicts and resulting uncertainties in these laws have been compounded by several recent federal court decisions. Following the introduction in part I, part II of this paper reviews applicable law and the court cases which have led to the confusion surrounding intellectual property financings.

PAGE ES-1 SUMMER 2001

The legal uncertainties in intellectual property-secured loan transactions have resulted in a series of very real practical problems, which are reviewed in part III of this paper. These practical issues have adversely affected both borrowers and lenders, as well as the federal agencies charged with responsibility for administering the federal patent, trademark and copyright laws, i.e., the U.S. Patent and Trademark Office ("PTO") and the U.S. Copyright Office ("Copyright Office"). In general, the legal uncertainties cause delays and significantly increase the costs of what would otherwise be routine lending transactions. Lenders have had to alter their normal lending and loan administration practices, and borrowers have been required to take actions which potentially conflict with their business plans. Moreover, the administrative burdens on the PTO and the Copyright Office have increased substantially, inasmuch as those offices now must receive and process secured loan documentation along with normal registration applications and ownership transfers. Chief among these practical problems are the following:

- Borrowers may be required to register, and thereby publicly disclose, otherwise confidential unregistered copyrights or trade secrets to enable the lender to obtain a perfected security interest in them.
- Borrowers may be required to record confidential agreements creating derivative rights such as licenses and royalties, which are not otherwise required to be recorded, to enable the lender to obtain a perfected security interest in those derivative rights.
- Borrowers holding licenses of unregistered copyrights may be required to attempt to have the licensor register its copyright, to enable the lender to obtain a perfected security interest in the license. As a practical matter, this will be impossible because the borrower usually has no leverage over the licensor after the license has been granted.
- Borrowers may be required to register product packaging and labels in the Copyright Office as a condition of ordinary inventory financing. Lenders may be compelled to record inventory security agreements in the Copyright Office, in addition to making routine state UCC filings. New registrations and recordings may be required over the life of the loan as packaging design changes are made.
- Lenders may be forced to record security agreements covering software embedded in manufactured products. If the embedded software is essential to the product's function, the product may have little or no collateral value without it.
- There is presently no efficient and cost-effective mechanism for recording documents in the PTO or Copyright Office that relate to multiple intellectual property rights. Under current PTO and Copyright Office procedures, borrowers and lenders must specifically identify each item of intellectual property collateral by registration number on a separate cover sheet and pay recording fees based on the aggregate number of patents, copyrights or trademarks covered by the recording.
- The PTO and the Copyright Office are inundated with recording requests relating to secured loan transactions. It is impossible to obtain up-to-date search reports of PTO or Copyright Office records because of the backlog of unprocessed recordings in each office.
- The backlog in the PTO and the Copyright Office is aggravated by the need under current law for lenders to make multiple, duplicative recordings of security agreements covering intellectual property acquired or developed by borrowers after the loan closing, and to record security agreements covering intellectual property rights (such as non-exclusive licenses) which are not otherwise subject to the federal recording system.

These issues have very real economic significance to borrowers and lenders. As more and more value in the American economy becomes attributable to intellectual property rights, the present uncertainties in the law will have an increasingly greater impact on commercial lending transactions and the availability of business credit. An integrated legislative solution would ease the burdens on the PTO and the Copyright Office and restore cost-efficiency and predictability to intellectual property-secured financings, for the benefit of all concerned.

WORKING CAPITAL FINANCING IN THE NEW ECONOMY:

Current Legal Issues and the Need for Federal Legislative Reforms

TABLE OF CONTENTS

Execu	ıtive Su	mmary	I		ES-1	
Prefac	ce and A	Acknov	vledgen	nents	iii	
I.	Intro	ductior	1		1	
II.	Legal	Backg	round:	The Uniform Commercial Code; the U.S. Bankruptcy Code;		
	Feder	, and the Intellectual Property Laws	2			
	A.	Perfection of Security Interests Under Article 9 of the Uniform Commercial Code				
	B.	Impact of the Borrower's Bankruptcy on a Creditor's Security Interest				
	C.	Federal Preemption of Article 9				
		1.	UCC	Provisions Addressing Federal Preemption	4	
		2.	Non-	Federal Intellectual Property Rights	5	
	D.	The Federal and State Intellectual Property Laws				
		1.	Paten	ts	5	
			(a)	Nature of Patents; The Patent Act of 1952	5	
			(b)	Case Law on Perfection of Security Interests in Patents	6	
			(c)	Remaining Uncertainties in Patent Financing	7	
		2.	Regis	tered and Unregistered Trademarks	8	
			(a)	Nature of Trademarks	8	
			(b)	The Trademark Statutes	8	
				(1) The Lanham Act B Federally Registered Trademarks	8	
				(2) State Protection of Trademarks	8	
			(c)	Case Law on Perfection of Security Interests in Trademarks	9	
			(d)	Remaining Uncertainties in Trademark Financing	9	

PAGE i SUMMER 2001

		3.	Registered and Unregistered Copyrights				
			(a) Nature of Copyrights				
			(b) The Copyright Act of 1976				
			(c) Case Law on Perfection of Security Interests in Copyrights				
			(d) The Legacy of the Peregrine and Avalon Decisions				
		4.	Mask Works				
			(a) Nature of Mask Works				
			(b) The Semiconductor Act of 1984				
		5.	Trade Secrets				
		6.	Licenses, Royalties and Other Rights Related to Intellectual Property 14				
			(a) State Law Foundations				
			(b) Royalties and Other Receivables Related to Patents,				
			Trademarks and Copyrights				
III.	"Rea	Real World" Problems in Commercial Financing Transactions					
	A.	Intro	duction				
	B.	PTO	PTO and Copyright Office Records				
		1.	Obtaining Search Reports				
		2.	Recording Documents in the PTO and the Copyright Office				
	C.	Multi	ltiple Intellectual Property Rights				
	D.	After-	er-Acquired Intellectual Property Rights				
	E.	Admi	lministrative Burdens on the PTO and the Copyright Office				
	F.	Unreg	registered Intellectual Property Rights				
	G.	Intell	ectual Property Licenses, Royalties and Accounts Receivable				
		1.	Exclusive and Non-Exclusive Licenses				
		2.	Royalties and Accounts Receivable				
	H.	Hybr	id Collateral				
		1.	Embedded Software				
		2.	Other Hybrid Collateral; Allocation Issues; Transformation Issues				
IV.	Prior	Attemp	attempts at Legislative Reform				
V.	Con	Conclusion					

WORKING CAPITAL FINANCING IN THE NEW ECONOMY:

Current Legal Issues and the Need for Federal Legislative Reforms

A REPORT BY
THE UNIFORM COMMERCIAL CODE COMMITTEE
BUSINESS LAW SECTION, STATE BAR OF CALIFORNIA
June 2001

Preface and Acknowledgements

This report surveys the current legal and practical issues in commercial financing transactions arising from the interaction of the federal intellectual property statutes, recent federal court decisions and the Uniform Commercial Code as enacted by the states. The Uniform Commercial Code Committee of the Business Law Section of the State Bar of California decided to undertake this report in 1999 after the U.S. House of Representatives failed to advance proposed legislation that would have cured many of the legal difficulties identified in this report. Committee members believe that some of the lobbyists and legislators involved in the 1999 House subcommittee hearings may not have been adequately informed of the scope or economic significance of these issues to U.S. businesses in need of working capital financing. The authors of this paper are all practicing financial lawyers, and the practical problems described in this report are based on the personal experiences of the authors, their professional colleagues and their clients.

This report has deliberately refrained from proposing draft amendments to the federal intellectual property statutes. There are differing potential legislative solutions to the issues addressed in this paper, and indeed, not all members of the Uniform Commercial Code Committee are in agreement as to the best legislative approach. The objective of this report is not to advocate specific draft legislation but rather to present the relevant legal and practical issues in an informative manner, for the benefit of all parties who may be interested or involved in any future legislative initiative.

The authors gratefully acknowledge the assistance of Uniform Commercial Code Committee members and others who provided background information or other helpful comments as this report was being prepared, including Mikel R. Bistrow, William A. Bower, Peter H. Carson, Ruth E. Gaube, Jerome A. Grossman, Nancy Leventhal, Paul J. Pascuzzi, David Sanchez, Jeffrey L. Schaffer, Raymond T. Sung, David W. Thill, Jeffrey S. Turner and Steven O. Weise.

PAGE iii SUMMER 2001

I. INTRODUCTION.

Many small and mid-sized companies in the U.S. rely heavily on debt financing to provide working capital for their day-to-day operations and to support opportunities for growth and expansion. Traditional manufacturing companies as well as companies operating in the "new economy" depend on lines of credit to moderate seasonality factors and other temporary cash flow disruptions. Yet working capital financing presents special risks to lenders. Lenders will not normally finance young growing companies without adequate collateral security, because new companies typically have not yet earned credit ratings high enough to borrow on an unsecured basis. 1 Many older companies never qualify for unsecured loans. Working capital lenders typically require collateral in the form of security interests² in the company's personal property,3 including accounts receivable, contract rights, inventory, equipment and other tangible and intangible personal property. The amount of working capital financing available will depend directly on the value of the company's personal property in which the lender can obtain validly perfected security interests.

With the recent explosive growth of technology industries in the U.S., a significant part of the value of many growing businesses now consists of intellectual

property rights, including federally registered patents, trademarks, copyrights and mask works, and unregistered rights such as trade secrets, which may be "patentable" or "copyrightable." Significant value may also be attributable to a company's rights as a licensor or licensee of intellectual property under exclusive or nonexclusive licenses. Copyrights and potentially copyrightable property rights may include many different types of software for core-business enterprise applications (such as manufacturing, sales, distribution and accounting) and intra-corporate networks, software embedded in other products (such as sophisticated machinery and electronic equipment), Internet websites, plans, specifications, formulas, manufacturing processes, know-how and other trade secrets. Some of these rights may be hybrids, in that they may encompass a patentable invention, as well as a copyright. Copyrights and copyrightable property rights also comprise a significant part of the value of companies in the business of entertainment, film and other media production, toy and game manufacturing, broadcasting and publishing.

The ready availability of working capital financing at reasonable rates is an important factor for the continued growth of the U.S. economy. The inability of lenders to obtain adequate collateral security from the assets of companies with significant intellectual property restricts the availability of credit and economic growth just as surely as a rise in interest rates. Moreover, the savings and loan excesses of the 1980's have led to more aggressive oversight by bank regulatory agencies such as the Federal Reserve Bank and the Office of the Comptroller of the Currency. In the face of this new regulatory climate, lenders are subject to more stringent requirements concerning loan collateral and loan-to-value ratios. Neither borrowing companies nor their lenders are wellserved by unnecessarily complex, confusing and expensive requirements for perfecting security interests in intellectual property rights.

In general, security interests in personal property are governed by state law, namely, Article 9 of the Uniform Commercial Code ("UCC"). As discussed more fully below, however, Article 9 may be preempted to some extent by federal law in some circumstances. The federal laws governing patents, copyrights and trademarks are

One fairly common situation involves a "start-up" company that has spent most of its initial equity capital on development of software or patentable processes yet to be marketed. At a certain point, the company will need additional financing to support its operations, but additional equity may be unavailable or may be too dilutive or otherwise disadvantageous to existing shareholders. At that point, the company has no inventory or other tangible personal property with which to secure a loan. (Its equipment is usually leased from third parties.) While the company may expect to receive significant cash flow in the future, at the time it needs financing the only valuable collateral that it has to offer to a lender is its technology.

² "Security interest" is the term of art under the Uniform Commercial Code for a lien or charge on personal property voluntarily granted to secure repayment of a debt or performance of an obligation, which enables the grantee to foreclose on the property in the event of the borrower's default. The creditor-grantee is referred to as the "secured party".

³ Working capital financing based upon the value of a borrower's personal property is often referred to in the commercial lending industry as "asset-based" financing. The security for asset-based loans is often referred to as a "floating lien" because it extends to property interests (such as accounts receivable and inventory) arising or acquired after the loan closing.

⁴ Of course, more established manufacturing companies typically also have a reservoir of valuable intellectual property rights, including patented technology, trade secrets and trademarks.

each separate statutory regimes which differ from one another in structure, content and purpose. Therefore, an analysis of the federal preemption issue is complicated ab initio, because it is different under each set of federal intellectual property statutes. This complexity and potential for confusion has been compounded by several recent federal court decisions addressing the preemption question. Indeed, the current law governing security interests in intellectual property rights is now so complicated that it has been described as "arguably dysfunctional." These legal complexities represent an additional risk factor for lenders, and adversely impact the collateral value of intellectual property and related rights. Inevitably, these uncertainties and risks are passed along to borrowers in the form of increased costs in lending transactions, or in the worst cases, an absolute refusal to lend.

Nearly forty years ago, the UCC replaced a patchwork of obsolete and inconsistent state laws regulating business and financial transactions. The primary goal of the UCC was to establish uniformity, certainty and predictability in the law in order to facilitate commercial transactions across state lines. Legal complexities and uncertainties do not promote efficient markets or economic growth. For the sake of cost-efficiency, lending transactions secured with intellectual property rights deserve a similar uniform and predictable legal framework.

This paper reviews current legal and practical issues in commercial financing transactions arising from the federal intellectual property statutes and recent court decisions. The problems addressed in this report are very much "real world" problems affecting a wide spectrum of borrowers and lenders throughout the U.S. economy. They are not confined to a single industry. As the Internet expands and the Information Age matures, intellectual property rights constitute an increasingly larger share of the economic value of many American businesses. It is essential that lawmakers recognize the economic significance of these issues, and act promptly to adopt legislation that will correct the problems identified in this report.

II Legal Background: The Uniform Commercial Code; the U.S. Bankruptcy Code; Federal Preemption, and the Intellectual Property Laws.

A. Perfection of Security Interests Under Article 9 of the Uniform Commercial Code.

Security interests in most types of personal property collateral are governed by Article 9 of the UCC as separately enacted in each state.6 Very generally, Article 9 requires a creditor who wishes to perfect⁷ a security interest in most types of personal property (including accounts receivable and other intangible property rights, as well as inventory and equipment) to file a financing statement in the office of the Secretary of State of one or more states.8 The financing statement is a brief form9 setting forth the debtor's name and address, the secured party's name and address, and a general description of all of the property serving as collateral for the loan. Filed financing statements are indexed so that they are retrievable either by the debtor's name or by the secured party's name. The filing fee is nominal, and it is not necessary for the lender to prepare and file separate financing statements for each item of collateral for the loan. In most states, financing statements are indexed promptly after receipt by the office of the Secretary of State, the official indexes can be searched easily, and summaries of financing statement filings are readily available on-line from independent search companies. In general, a properly filed financing statement will assure that the lender has

PAGE 2 SUMMER 2001

⁵ A. Haemmerli, Insecurity Interests: Where Intellectual Property and Commercial Law Collide [hereinafter referred to as Haemmerli], 96 Colum. L. Rev. 1645, 1648 (1996).

As discussed in the following text paragraph, Article 9 has been subject to major revisions which will become effective in most states on July 1, 2001. In this report, the term "Article 9" refers both to old Article 9 and to Revised Article 9, unless otherwise indicated.

^{7 &}quot;Perfection" is a term of art under the UCC describing the legal status of a security interest as effective to give it priority over unperfected security interests, judgment liens and the interest of the trustee in bankruptcy.

⁸ Under "old" Article 9, financing statements must be filed in the state where the debtor's chief executive office is located and in any other state where the debtor has goods. Under Revised Article 9, in most cases, financing statements need be filed in only one state.

⁹ The form is usually designated "Form UCC-1" and referred to as a "UCC-1". In this report, financing statements required by Article 9 are sometimes referred to as "UCC-1 financing statements," and the act of filing a UCC-1 financing statement for the purpose of perfecting a security interest in personal property collateral is referred to as a "UCC filing."

priority in its loan collateral over subsequent lenders, judgment-lien holders and, in the event of the debtor's bankruptcy, the bankruptcy trustee.

Recently, Article 9 of the UCC has been the subject of a major revision effort having the dual objectives of further simplifying the procedures for creation, perfection and enforcement of security interests, and of expanding the types of property and transactions that fall within its scope. Revised Article 9 will become law in most states on July 1, 2001. Among other things, Revised Article 9 is intended to accommodate electronic transactions and to encourage development of systems for electronic filing of UCC-1 financing statements. Under Revised Article 9, a creditor wishing to perfect a security interest in most types of collateral need file a financing statement in only one state, the state of the debtor's "location". For debtors that are limited partnerships, limited liability companies or corporations, this will be the state where the debtor was organized or incorporated. The formal requirements for financing statements have also been simplified to permit very generic identification of collateral and to eliminate the requirement of the debtor's signature. As a result of the changes to be implemented under Revised Article 9, it should be easier than ever for creditors to perfect security interests in most types of collateral by UCC-1 financing statement filings.

B. Impact of the Borrower's Bankruptcy on a Creditor's Security Interest.

Perfection of the creditor's security interest is critical to preservation of the creditor's interest in the collateral in the event of the borrower's bankruptcy. Upon the filing of a bankruptcy petition, an estate is created which includes substantially all of the debtor's property interests. The estate is subject to the administration and control of the bankruptcy trustee or (in the case of a Chapter 11 reorganization) the debtor-in-possession, and to the general oversight of the federal bankruptcy judge. Ultimately, the property in the estate is liquidated, or, in a Chapter 11 case, reorganized pursuant to a court-approved plan, in order to repay the debtor's prepetition creditors.

Property of the bankruptcy estate includes property subject to liens and security interests, although a creditor holding a valid pre-petition lien or security interest in estate property is entitled to receive the value of its security upon distribution of estate assets.¹¹ In general, the composition of property of the estate and the status of liens and security interests in such property are questions determined by applicable state law (including the UCC), rather than federal bankruptcy law.¹² The U.S. Bankruptcy Code, however, invests the bankruptcy trustee with a series of extraordinary powers to recover property for the benefit of estate creditors.¹³ These powers include the so-called "strong-arm" power of \$544(a)(1) of the U.S. Bankruptcy Code to void unperfected security interests in personal property.¹⁴

As a result of the trustee's "strong-arm" power, an unperfected security interest generally will not survive a borrower's bankruptcy filing. The trustee (or the debtorin-possession in a Chapter 11 case), as the representative of the estate's unsecured creditors, has the right to bring an action in the bankruptcy court to have any unperfected security interests declared void. A creditor with a security interest that has been avoided by the bankruptcy trustee is on a par with unsecured creditors in the case, and may recover little or nothing on its claim. Because of this potentially draconian result, the federal bankruptcy court is the situs for vigorous priority contests between secured creditors and trustees (or debtors-inpossession), and most case-law precedent governing the perfected or unperfected status of security interests consists of bankruptcy court decisions. Ultimately, it is the "strong-arm" power of the bankruptcy trustee or debtorin-possession that is the foundation for the concerns expressed in this report. Only *perfected* security interests in intellectual property will be enforceable against the trustee or debtor-in-possession in a bankruptcy case.

¹¹ See 11 U.S.C. § 506(a).

Congress left the determination of property rights in bankruptcy cases to applicable state law. *Butner v. U.S.*, 440 U.S. 48, 54, 99 S.Ct. 914, 918, 59 L.Ed.2d 136 (1979).

¹³ See 11 U.S.C. §§ 544 - 550.

^{14 11} U.S.C. § 544(a)(1). With respect to personal property, the bankruptcy trustee has the legal status of a hypothetical lien creditor. *Id.*; U.C.C. § 9-301. With respect to real property, the trustee has the legal status of a bona fide purchaser. 11 U.S.C. §544(a)(3). In addition to the "strong-arm" powers under 11 U.S.C. § 544, the trustee's turnover powers also include the power to avoid preferential transfers and fraudulent conveyances. See 11 U.S.C. §§ 547, 548.

¹⁰ See 11 U.S.C. § 541(a).

C. Federal Preemption of Article 9.

Intellectual property rights are intangible *personal property* rights. Security interests in intellectual property are therefore governed by Article 9 of the UCC, except to the extent that the federal intellectual property laws operate to preempt Article 9. In general, the scope of federal preemption of any state law is a matter determined by the federal courts under the Supremacy Clause of the U.S. Constitution.¹⁵ State law on any topic may be preempted either (i) by express language in a federal statute, (ii) by implication, depending upon the scope of federal regulation of the subject matter and the nature of the federal interest involved, or (iii) to the extent that an actual conflict between federal and state law exists.¹⁶

1. UCC Provisions Addressing Federal Preemption.

Article 9 of the UCC is subject to federal preemption in the same manner as any other state law. The original drafters of old Article 9 addressed the possibility of federal preemption in two so-called "step-back" provisions.¹⁷ The first of these - the broader of the two - is § 9-104(a), which addresses the general applicability of Article 9. Section 9-104(a) provides that (old) Article 9 does not apply to a security interest subject to any federal statute to the extent that such statute governs the rights of parties to, and third parties affected by, transactions in the type of property subject to the statute.¹⁸ The corresponding provision of Revised Article 9, § 9-109(c)(1), is drafted in a less elliptical fashion as follows: "This article does not apply to the extent that: (1) a statute, regulation, or treaty of the United States preempts this article; . . . " The drafters of Revised Article 9 intended that Article 9 defer to federal law "only when and to the

extent that it must – i.e., when federal law preempts it."¹⁹ Nevertheless, in light of the federal court decisions reviewed in part II.D below, the scope of preemption of Article 9 by the federal intellectual property laws remains an issue even after the recent Article 9 revision efforts.

The second old Article 9 "step-back" provision, § 9-302(3)(a), is more narrowly focused on the requirements for perfection of security interests in certain specific types of property regulated by federal law, such as civil aircraft. Section 9-302(3)(a) provides that the filing of a financing statement "is not necessary *or effective*" for perfection of a security interest in property subject to:

(a) A statute or treaty of the United States which provides for a national or international registration or a national or international certificate of title or which specifies a place of filing different from that specified in this Article for filing of the security interest.²⁰

Section 9-302(3)(a) addresses perfection only, and renders state-level UCC-1 financing statement filings *ineffective* to the extent they cover property subject to the type of federal laws described in subsection (3)(a). If §9-302(3)(a) applies, *only* a federal-level filing will be effective to perfect a security interest in such property.

The corresponding provision of Revised Article 9 is § 9-311(a)(1), which provides that "...the filing of a financing statement is not necessary or effective to perfect a security interest in property subject to:

(1) A statute, regulation, or treaty of the United States whose requirements for a security interest's obtaining priority over the rights of a *lien creditor* with respect to the property preempt Section 9-310(a); . . . "21

The new language of Revised Article 9 represents an attempt on the part of the drafters to limit the instances

PAGE 4 SUMMER 2001

¹⁵ U.S. Const., art. VI, cl. 2.

¹⁶ See New York State Conf. Of Blue Cross & Blue Shield Plans v. Travelers Ins. Co., 514 U.S. 645, 654, 115 S.Ct. 1671,1676, 131 L.Ed.2d 695 (1995); Hillsborough Cty. v. Automated Medical Labs., Inc., 471 U.S. 707, 713, 105 S.Ct. 2371, 2375, 85 L.Ed. 2d 714 (1985).

¹⁷ The term "step-back" is actually an inappropriate metaphor because it implies that federal preemption somehow depends on whether the state statute in question expressly yields to federal law. In fact, as noted in the text above, the scope of federal preemption of a state statute is determined by federal law, in accordance with the federal authorities cited in notes 15 and 16 above. Revised Article 9 more accurately reflects this. See *infra note* 19 and accompanying text.

¹⁸ U.C.C. § 9-104(a). Official Comment 1 to § 9-104(a) explains that Article 9 does not govern security interests regulated by a federal statute which governs the incidents of security interests in particular kinds of property (such as aircraft liens required to be registered with the Civil Aeronautics Board pursuant to the Federal Aviation Act of 1958) and which provides that such registration is the equivalent of a UCC-1 financing statement filing under Article 9.

¹⁹ Official Comment 8 to Revised U.C.C. § 9-109. Official Comment 8 suggests that the text of old Article 9's § 9-104(a) had been interpreted in a manner that was too deferential to federal law.

²⁰ U.C.C. § 9-302(a) (emphasis added).

of federal preemption to federal statutes that specifically address the rights of "lien creditors." This term of art includes other secured parties, judgment-lien holders and, in bankruptcy, the trustee or debtor-in-possession, but does not include *purchasers* of ownership rights in the property in question. Notwithstanding this effort by the drafters of Revised Article 9, the scope of federal preemption of Article 9 is ultimately a matter of federal law, determined solely by the language of federal statutes and federal court decisions interpreting those statutes.

As discussed in part II.D below, the federal patent, copyright and trademark statutes each provide for national registration of *ownership* rights in the intellectual property subject to the statutes. The legal issue under each set of statutes is whether and to what extent the federal-level registration system for *ownership rights* in patents, copyrights or trademarks (as the case may be) is sufficient to preempt the Article 9 state-level filing system for *security interests* in the same type of intellectual property and in derivative rights such as royalties and accounts receivable.

As presently written, the federal patent and trademark laws do not preempt the Article 9 financing statement-filing requirements because they do not provide for federal recordation of security interests.²² The language of the federal copyright law is broader, however. It defines "transfer" to include a mortgage or hypothecation, and sets forth the requirements for valid transfers.²³ The federal copyright law therefore appears to fall within the old Article 9 "step-back" rule of U.C.C. § 9-302(3)(a),²⁴ and, as discussed in part II.D.3 below, two federal courts have ruled that filing a UCC-1 financing statement at the state level only is *not effective* to perfect a security interest in a copyright. It is uncertain how a court would interpret the federal copyright law in light of Revised U.C.C. § 9-311(a)(1).

2. Non-Federal Intellectual Property Rights.

In reviewing the scope of federal preemption of Article 9 of the UCC, it is important to note that not all intellectual property rights are created or regulated by

federal law. Federal registration of copyrights and trademarks is voluntary, not mandatory, and both copyrights and trademarks may exist in unregistered form. Trademarks may be registered under state law alone. Trade secrets as such are governed exclusively by state law (although a trade secret may be eligible to be patented or copyrighted). There are numerous other rights related to or derived from intellectual property rights, such as licenses, sublicenses, royalties and accounts receivable, that are not regulated substantively by the federal intellectual property statutes and therefore should be subject only to Article 9. As to these rights, federal preemption should not be an issue at all.²⁵ One recent bankruptcy court decision (now on appeal to the Ninth Circuit) has held that security interests in *unregistered* copyrights are not required to be recorded in the Copyright Office, but are governed solely by the UCC.26 Nevertheless, as discussed below, other earlier federal court decisions have created a substantial level of uncertainty as to the status of these derivative rights.

D. The Federal and State Intellectual Property Laws.

1. Patents.

(a) Nature of Patents; The Patent Act of 1952

Patent rights are created by, and subsist under, federal law exclusively. A patent is a federal grant under the Patent Act of 1952, as amended (the "Patent Act"), 27 of a monopoly to an inventor for a limited period of time covering the right to use, manufacture, license and sell an invention. As the holder of a federally authorized monopoly, the owner of a patent has the right to prevent any other person from manufacturing, using, licensing

Revised U.C.C. § 9-311(a)(1) (emphasis added). The reference to Revised U.C.C. § 9-310(a) is a reference to the general UCC requirement that a financing statement filing is necessary to perfect substantially all security interests in personal property.

²² See generally infra text accompanying notes 33-34 and 45-47.

²³ See 17 U.S.C. §§ 101, 204-205.

But see infra note 61.

²⁵ See generally infra part II.D.6.

²⁶ See Aerocon Engineering Inc. v. Silicon Valley Bank (In re World Auxiliary Power Co., et al.), 244 B.R. 149, 156 (Bankr. N.D. Cal. 1999), aff'd 2000 U.S. Dist. LEXIS 20687 (N.D. Cal. July 13, 2000), appeal docketed, No. 00-16550 (9th Cir. ______, 2000). The Aerocon court noted, however, that a state-level UCC filing would be vulnerable to invalidation if the unregistered copyright were later registered and a competing security interest had been recorded in the Copyright Office. For that reason, the court recommended that prudent secured creditors also record their security agreements in the Copyright Office simultaneously with their state-level UCC filings. Id. at 154 n.11.

^{27 35} U.S.C.§§ 1 et seq.

or selling the invention for the duration of the patent. A utility patent may cover any new and useful process, machine, manufacture or composition of matter, or any new or useful improvement to any of these categories. A design patent may cover a design if it is innovative, nonfunctional and part of a functional manufactured product.

The Patent Act does not specifically address security interests in patents. Section 261 of the Patent Act, however, governs patent assignments and priorities between certain types of competing claimants:

An assignment, grant or conveyance shall be void as against any subsequent purchaser or mortgagee for a valuable consideration, without notice, unless it is recorded in the [U.S. Patent and Trademark Office] within three months from its date or prior to the date of such subsequent purchase or mortgage.²⁸

The regulations under § 261 state that assignments will be recorded, and "[o]ther documents, accompanied by completed cover sheets . . . will be recorded as provided in this part or at the discretion of the Commissioner." Thus, the form of cover sheet required by the U.S. Patent and Trademark Office ("PTO") for documents to be recorded (PTO Form 1619A) requests a description of the "Conveyance Type" being recorded, and lists the following choices: "Assignment", "License", "Merger", "Security Agreement", "Change of Name" and "Other".

The legislative history of the Patent Act does not indicate whether the drafters intended to include security interests within the meaning of the term "assignment". Under the predecessor statute to the Patent Act, the U.S. Supreme Court held that the granting of a patent mortgage was equivalent to an absolute assignment of the patent to the mortgagee.³¹ It is doubtful, however, that this analysis – which predated the UCC –

has any present-day relevance. Modern security interests in patents are enforceable even if the secured party does not obtain title to the patent, and therefore need not be structured as absolute assignments.³² There is also confusion concerning the reference in § 261 to a "mortgagee." It is not clear whether this term was intended to refer to secured creditors generally or only to patent mortgagees. Since adoption of the UCC, the entire concept of a patent mortgage has become obsolete. It is evident that the Patent Act needs updating to reflect current practices regarding security interests in patents and to incorporate modern terminology from Article 9 of the UCC.

(b) Case Law on Perfection of Security Interests in Patents.

Moldo v. Matsco (In re Cybernetic Services, Inc.)³³ is the most recent in a line of bankruptcy cases holding that, to perfect a security interest in a patent, a creditor must file a UCC-1 financing statement under applicable state law, but that it is not necessary for the creditor to record its security agreement or a patent assignment in the PTO. In Cybernetic Services, the bankruptcy trustee challenged perfection of a lender's security interest under the "strong arm" clause of the Bankruptcy Code. The court considered whether the terms "assignment, grant or conveyance" in § 261 of the Patent Act include a grant of a security interest, and whether the terms "subsequent purchaser or mortgagee" in § 261 include a secured party or other lien creditor such as the bankruptcy trustee.³⁴ The court found that all three terms, "assignment," "grant" and "conveyance," refer to transfers of ownership interests in patents and were not intended to include creation of security interests. In the Ninth Circuit's view, security interests are analogous to nonexclusive patent licenses, which need not be recorded. Moreover, the bankruptcy trustee did not have the status of a "subsequent purchaser or mortgagee" because the trustee did not hold title to the patent. The court therefore held

PAGE 6 SUMMER 2001

^{28 35} U.S.C. § 261.

²⁹ 37 C.F.R. § 3.11(a).

³⁰ The PTO is part of the U.S. Department of Commerce. It is responsible for processing patent and trademark applications, registering issued patents and approved trademarks, and maintaining all records concerning registered patents and trademarks. It issues regulations governing patent and trademark procedures, and is the situs for hearings before the Board of Patent Appeals.

³¹ Waterman v. MacKenzie, 138 U.S. 252, 11 S.Ct. 334, 34 L.Ed. 923 (1891).

³² In addition, secured parties desire to avoid assuming liability for patent infringement. *See infra* notes 37-38 and accompanying text.

^{33 252} F.3d 1039 (9th Cir. 2001); *City Bank and Trust Co. v. Otto Fabric, Inc.*, 83 B.R. 780 (D. Kan. 1988); *In re Transportation Design and Technology, Inc.*, 48 B.R. 635 (Bankr. S.D. Cal. 1985).

 $^{^{34}}$ Under U.C.C. § 9-301(3) and § 544(a) of the Bankruptcy Code, the bankruptcy trustee is deemed to be a "lien creditor" from the date of filing of the bankruptcy petition.

that the Patent Act does not preempt the UCC with respect to perfection of security interests in patents. The court also held that the Patent Act does not provide a federal filing system for perfection of security interests in patents within the meaning of U.C.C. § 9-302(3)(a). The secured creditor in *Cybernetic Services*, who had filed a UCC-1 financing statement under applicable state law but had not made any recordings in the PTO, therefore prevailed against the bankruptcy trustee.

The Ninth Circuit in *Cybernetic Services* acknowledged the difficulty of reconciling the modern law of secured transactions in Article 9 of the UCC with a federal statute that incorporates archaic terminology, but declined to rewrite the Patent Act. The court observed that the issue before it was one of statutory construction, and its opinion was limited to the applicability of the statute to the facts of the case. The Ninth Circuit did not address the practical question whether a secured party must record its security agreement in the PTO nonetheless, in order to give constructive or actual notice of its rights as a secured creditor to a good faith purchaser of an ownership interest in the patent.

The cases are consistent, but create an uncertain peace in the area of perfection and priority of security interests in patents. In In re Transportation Design and Technology, Inc.,35 the bankruptcy court acknowledged that there is a "fairly narrow area remaining for state regulation" of security interests in patents, and that the UCC should continue to apply to priority disputes among secured creditors and judgment lien creditors who have not recorded in the PTO. Transportation Design did not involve a priority dispute between a secured creditor and a transferee of the patent without notice of the security interest, the court also remarked that a secured creditor must record its security agreement with the PTO in order to prevent the borrower from transferring title to the patent free and clear of the creditor's security interest before the debt is repaid.³⁶ Accordingly, in addition to making state-level UCC filings, most lenders also record their security

agreements in the PTO, in an effort to give actual notice of their security interest to any potential transferee of an ownership interest in the patent.

(c) Remaining Uncertainties in Patent Financing.

Recording patent security agreements in the PTO constitutes a significant extra step that results in additional costs and delays in lending transactions. As discussed in part III of this paper, recordation of documents in the PTO is more cumbersome and more expensive than state-level UCC filings, and PTO recordings will not cover patents acquired by the borrower after the loan closing. Moreover, unlike a UCC filing which is effective immediately, § 261 of the Patent Act provides for a three-month "grace period" after execution of a patent assignment before it must be recorded in the PTO in order to impart constructive notice to subsequent purchasers. Accordingly, a search of the records of the PTO will not necessarily disclose all potentially effective assignments of a patent. Any patent assignment which is signed within the three-month period before a security agreement is recorded in the PTO could take priority over the security interest if the assignment is recorded within three months after its signing.

Another issue relates to the form of the security document to be recorded. Historically, lenders' counsel required borrowers to execute separate collateral assignments for recording with the PTO, in addition to security agreements and related UCC-1 financing statements filed at the state level. The assignments described the patents and were typically structured as absolute assignments with a license back to the borrower. This practice represented an attempt to fit the transaction within the specific language of § 261 of the Patent Act, but is now strongly disfavored. An assignment transfers record title to the patent, and could subject the lender to liability for patent infringement.³⁷ Moreover, a lender who is a patent assignee may be an indispensable party, as a procedural matter, in any patent infringement action.³⁸ A

^{35 48} B.R. 635, 640 (Bankr. S.D. Cal. 1985).

³⁶ *Id. See also Moldo v Matsco (In re Cybernetic Services, Inc.)*, 239 B.R. 917, 921 n.10 (Bankr. 9th Cir. 1999), *aff'd* 252 F.3d 1039 (9th Cir. 2001) (noting that the recording of a security interest is discretionary on the part of the PTO, and therefore serves to provide actual notice, rather than constructive notice, to bona fide purchasers of patents).

³⁷ Because the Patent Act was not intended to regulate security interests, it does not contain a section analogous to U.C.C. § 9-317, which exculpates a secured party from contract or tort liability for the debtor's acts or omissions.

³⁸ Even if the lender has an enforceable contractual indemnity from its borrower, a lender named in a patent infringement case must retain counsel, make court appearances and seek to be dismissed as a party to the action.

lender-assignee could also become liable for maintenance expenses relating to the patent. Currently, the more accepted practice is to record a counterpart of the security agreement itself³⁹ in the PTO, or alternatively a short-form document which restates the grant of the security interest, identifies the patents in compliance with PTO recording requirements and cross-references the security agreement. The document recorded in the PTO will recite that it creates a security interest (or is a conditional assignment for security) only, and is not an absolute assignment of ownership of the patent. These practice issues highlight the remaining uncertainties in the law of patent security interests - which consists of two independent statutory schemes not designed to work together - and the resulting need for corrective legislation.

2. Registered and Unregistered Trademarks.

(a) Nature of Trademarks.

Trademarks are words, names, logos, symbols or other devices used by a manufacturer, distributor or retailer to identify the source of a product and to distinguish it from products offered by others. A service mark is essentially the same thing as a trademark, except that it promotes services rather than products. Trademark rights are acquired through usage in commerce. Unlike patents and copyrights, they are not created by federal law; they are fundamentally common-law rights, although they may be registered federally (and thereby protected by federal law) if used in interstate commerce. Trademarks may also be registered locally, under state statutes. Registration provides protection against infringement and other enforcement rights. A trademark owner has the exclusive right to use the mark, and federal registration is prima facie evidence of the validity and ownership of the trademark. Trademarks are a of the goodwill of a business; therefore, a valid transfer of a trademark must include the goodwill associated with the mark.⁴⁰

(b) The Trademark Statutes.

(1) The Lanham Act – Federally Registered Trademarks.

The Trademark Act of 1946, as amended (popularly referred to as the "Lanham Act"),⁴¹ is the federal statute governing trademark rights. Like the Patent Act, the Lanham Act does not expressly address security interests, but includes provisions in § 1060 governing assignments of federally-registered trademarks, as follows:

(a) A registered mark or a mark for which an application to register has been filed shall be assignable with the good will of the business in which the mark is used, or with that part of the good will of the business connected with the use of and symbolized by the mark. . . . An assignment shall be void against any subsequent purchaser for valuable consideration without notice, unless the prescribed information reporting the assignment is recorded in the Patent and Trademark Office within 3 months after the date of the assignment or prior to the subsequent purchase. . . . ⁴²

As in the case of patent security agreements, the PTO has discretion to accept, and normally will accept, for recording a security agreement covering a trademark, notwithstanding that the Lanham Act does not specifically provide for the recording of security agreements (unless construed as an absolute assignment under § 1060 above). The PTO Recordation Form Cover Sheet for Trademarks (Form PTO-1618A) includes "Security Agreement" as an option to be checked in the area of the form for designation of the "Conveyance Type."

(2) State Protection of Trademarks.

In addition to the Lanham Act, most states have statutes providing for the registration of trademarks and providing remedies for infringement.⁴³ State registration is appropriate for local enterprises or non-profit agencies that do not do business in interstate commerce. State trademark records are usually maintained by the Secretary of State. State trademark statutes typically include provisions governing assignments which parallel § 1060 of the Lanham Act.⁴⁴ Therefore, a state trade-

PAGE 8 SUMMER 2001

³⁹ Of course, the security agreement and the related UCC-1 financing statement should also refer to after-acquired patents and derivative rights such as license rights, royalties, licensing fees and other proceeds.

⁴⁰ In *The Clorox Co. v. Chemical Bank*, 10 U.S.P.Q.2d 1098 (July 2, 1996), the Trademark Trial and Appeal Board of the PTO invalidated an absolute assignment of a trademark application given to a lender as security, as well as the underlying trademark application, because the assignment was not accompanied by a transfer of the assignor's business and therefore violated the Lanham Act.

^{41 15} U.S.C. §§ 1051 et seq.

⁴² 15 U.S.C. § 1060.

⁴³ See, e.g., Cal. Bus. & Prof. Code §§ 14200 et seq.

⁴⁴ See, e.g., Cal. Bus. & Prof. Code § 14260.

mark statute may raise an issue whether notice of a trademark security interest should be filed in the state trademark records as well as in the state UCC records.

(c) Case Law on Perfection of Security Interests in Trademarks.

Courts have construed the Lanham Act narrowly, holding that the Act was not intended to govern security interests in trademarks and therefore does not preempt Article 9 under U.C.C. § 9-104(a). In addition, the courts have found that the Lanham Act does not provide a federal filing system for perfection of security interests in trademarks within the meaning of U.C.C. § 9-302(3)(a). The cases have uniformly held that a secured creditor need only file a proper UCC-1 financing statement to perfect a security interest in a trademark, even if the trademark itself is registered with the PTO or is eligible for federal registration. For example, in In re Roman Cleanser Co., 45 the trustee in bankruptcy challenged the lender's security interest in the debtor's name "Roman Cleanser", a federally registered trademark. The bankruptcy court reviewed the language and intent of the Lanham Act, and held that the Act does not require the recording of security agreements that do not constitute absolute assignments. In Roman Cleanser, the lender had described "all general intangibles" in its UCC-1 financing statement filing, and the court held this description sufficient to perfect a security interest in the trademark at issue.

The only successful challenges to perfection of trademark security interests have been based on improper collateral descriptions, as distinct from any requirement that the security interest be recorded with the PTO. In fact, in *Joseph v. 1200 Valencia, Inc. (In re 199Z, Inc.)*, 46 the lender was held to be unperfected because of an improper collateral description in the UCC-1 financing statement, even though the lender had also recorded a security agreement with the PTO. The court found that the PTO filing was not relevant to the determination, because the Lanham Act does not require (or contemplate) the recording of security interests. 47

(d) Remaining Uncertainties in Trademark Financing.

Trademarks are important collateral, not only for their intrinsic value as brand names, but also because a lender may not be able to enforce a security interest in trademarked inventory without a perfected security interest in the trademark as well as in the inventory itself. To perfect a security interest in a federally registered trademark, practitioners advise recording a trademark security agreement with the PTO (notwithstanding that the Lanham Act does not address security interests), in addition to a state-level filing of a UCC-1 financing statement. As in the case of patent security agreements, 48 if a PTO recording is not made, a good faith purchaser of the trademark, who would not otherwise have notice of the security interest, may cut off a lender's rights. Following the Trademark Trial and Appeal Board's decision in The Clorox Co. v. Chemical Bank, 49 it is not advisable to use a collateral assignment instead of a security agreement to evidence a security interest in a trademark. As noted above, any trademark assignment that is not accompanied by an assignment of the underlying goodwill and assets of the business will be invalid.

The PTO's recordation requirements for documents relating to trademarks, including the use of special document cover sheets, are substantially similar to the PTO's requirements for recording documents relating to patents. ⁵⁰ Recording trademark security agreements in the PTO is therefore subject to the same practical problems that impact patent security interest documentation, as discussed in part III of this paper below.

1. Registered and Unregistered Copyrights. (a) Nature of Copyrights.

A copyright gives the creator of an artistic, literary, musical or similar creative work the exclusive right to

^{45 43} B.R. 940 (Bankr. E.D. Mich. 1984), *aff'd*, 802 F.2d 207 (6th Cir. 1986).

^{46 137} B.R. 778 (Bankr. C.D. Cal. 1992).

⁴⁷ See also In re Together Development Corp., 227 B.R. 439 (Bankr. D.Mass. 1998) (recording only with PTO did not perfect security interest in trademark).

⁴⁸ See supra text accompanying notes 35-36.

^{49 10} U.S.P.Q.2d 1098 (July 2, 1996). The *Clorox* case highlights the issues concerning so-called "intent-to-use" trademark filings, where a trademark application is filed with the PTO before the mark has been put to use in commerce and has had a chance to develop related goodwill. Although a lender may take a security interest in an "intent-to-use" trademark, the lender will be unable to foreclose on the mark until there is goodwill associated with it.

⁵⁰ To be recorded in the PTO, a trademark security agreement must specifically describe each trademark intended to be subject to the agreement, and set forth its PTO registration or application number.

reproduce, distribute, publicly perform and publicly display such work, and to prepare derivative works. Copyright protection is granted by federal law.⁵¹ Basic copyright protection exists in "[o]riginal works of authorship fixed in any tangible medium of expression, now known, or later developed, from which they can be perceived, reproduced or otherwise communicated, either directly or with the aid of a machine or device."52 For a work to qualify for federal copyright protection, it must (1) be original, (2) constitute the expression of an idea, rather than the idea itself, and (3) be fixed in a tangible medium of expression, such as paper, canvas, audio or video tape, film or a computer disk. The threshold for a work to be entitled to copyright protection is extremely minimal (and substantially lower than comparable thresholds for patent or trademark protection). Almost any original creative content will suffice, and novelty or uniqueness is not required.53

The owner of a copyright is permitted to register the copyright with the U.S. Copyright Office (the "Copyright Office"),⁵⁴ but is not required to do so.⁵⁵ Thus, a copyright may exist and be entitled to basic copyright protections under federal law, even in the absence of federal registration.⁵⁶ As discussed in more detail below, the proper manner of perfecting security interests in works that have not been registered with the Copyright Office but which are eligible for registration (so-called "copyrightable" works) has been the subject of much controversy and confusion.

(b) The Copyright Act of 1976.

The Copyright Act of 1976, as amended (the "Copyright Act"),⁵⁷ is the federal statute governing copy-

rights. Unlike the Patent Act and the Lanham Act, the Copyright Act includes references to security interests in copyrights. Section 205(a) of the Copyright Act provides that, "[a]ny transfer of copyright ownership or other document pertaining to a copyright may be recorded in the Copyright Office . . .". 58 A "transfer" under the Copyright Act is defined to include any "mortgage" or "hypothecation of a copyright." 59 The terms "mortgage" and "hypothecation of a copyright have been interpreted to mean a security interest in a copyright. 60 This terminology constitutes the basis for the court decisions that copyright security agreements must be recorded in the Copyright Office in order to perfect security interests in copyrights. 61

Section 205 of the Copyright Act addresses the effect of recordation of a document in the Copyright Office and the priority of conflicting transfers:

- (c) Recordation as constructive notice. Recordation of a document in the Copyright Office gives all persons constructive notice of the facts stated in the recorded document, but only if
 - (1) the document, \dots specifically identifies the work to which it pertains \dots ; and

PAGE 10 SUMMER 2001

^{51 17} U.S.C. § 101 *et seq.* The primary goal of the Copyright Act is to encourage creativity and innovation by facilitating the commercial exploitation of copyrighted works and the prospect of a fair economic return to the creator. *See generally Fogarty v. Fantasy, Inc.*, 510 U.S. 517, 526 (1994); *Sony Corp. of America v. Universal City Studios, Inc.*, 464 U.S. 417, 429 (1984).

⁵² 17 U.S.C. § 102.

⁵³ *See, e.g., Nimmer on Copyrights,* ¶ 2.08 [g], pp. 2-135 *et seq.* (M. Bender); 17 U.S.C. § 102(b); 37 C.F.R. § 202.1.

⁵⁴ The Copyright Office is part of the Library of Congress.

⁵⁵ See 17 U.S.C. § 208 (a).

 $^{^{56}}$ Nevertheless, a copyright owner must register the copyright with the Copyright Office in order to enforce a copyright infringement claim against a third party. 17 U.S.C. §§ 410, 411.

⁵⁷ 17 U.S.C. 101 *et seq*.

 $^{^{58}\,}$ 17 U.S.C. 205(a). The phrase "pertaining to a copyright" is defined in the Copyright Office regulations as a document having "a direct or indirect relationship to the existence, scope, duration, or identification of a copyright, or to the ownership, division, allocation, licensing, transfer, or exercise of rights under a copyright. That relationship may be past, present, future, or potential." 37 C.F.R. § 201.4(a)(2).

⁵⁹ 17 U.S.C.§§ 101, 201(d)(1).

⁶⁰ See, e.g., National Peregrine Inc. v. Capitol Fed. Savings and Loan Assn. of Denver (In re Peregrine Entertainment Ltd.), 116 B.R. 194, 199 (C.D. Cal. 1990).

⁶¹ The drafters of Article 9 of the UCC apparently did not view the language of the Copyright Act as broad enough to preempt the UCC. Official Comment 1 to (old) U.C.C. § 9-104(a) notes that: "Although the Federal Copyright Act contains provisions permitting the mortgage of a copyright and for the recording of an assignment of a copyright . . . such a statute would not seem to contain sufficient provisions regulating the rights of the parties and third parties to exclude security interests in copyrights from the provisions of this Article." This Comment, however, refers to the Copyright Act of 1909, which was repealed in 1976. Accordingly, the Comment has not influenced the interpretation of current federal law. See Haemmerli. 96 Colum. L. Rev. at 1664-65.

- (2) registration has been made for the work.
- (d) *Priority between conflicting transfers.* As between two conflicting transfers, the one executed first prevails if it is recorded, in the manner required to give constructive notice under subsection (c), within one month after its execution . . . or at any time before recordation in such manner of the later transfer. Otherwise the later transfer prevails if recorded first in such manner, and if taken in good faith, for valuable consideration . . . and without notice of the earlier transfer.⁶²

The Copyright Office, like the PTO, requires the use of document cover sheets for recordation of documents. The current form of document cover sheet includes "Security Interest" on the list of categories of documents that may be recorded, and requires that the title of the work to which the document relates be identified.

Like § 261 of the Patent Act, the Copyright Act provides for a "grace period" after execution of a copyright transfer document before it is required to be recorded in the Copyright Office in order to give constructive notice to subsequent purchasers. Under § 205(c) of the Copyright Act, the grace period is one month. ⁶³ Therefore, any copyright transfer document which is *signed* within the one-month period before a security agreement is recorded in the Copyright Office could take priority over the security interest if the transfer document is recorded within one month after its signing, even if such recording occurs *after* the recording of the security agreement.

(c) Case Law on Perfection of Security Interests in Copyrights.

National Peregrine Inc. v. Capitol Fed. Savings and Loan Assn. of Denver (In re Peregrine Entertainment Ltd.)⁵⁴ was the first reported case to address security interests in copyrights and the federal preemption question. In Peregrine, the United States District Court for the Central District of California ruled that the Copyright Act established a comprehensive national system for recording transfers of copyright interests, which

was sufficient under § 9-302(3)(a) of the UCC to extend to security interests in copyrights. The court held that "[r]ecording in the U.S. Copyright Office, rather than filing a financing statement under Article Nine [of the UCC], is the proper method for perfecting a security interest in a copyright." In what many consider an unwarranted leap of logic, the court further indicated in dicta that security interests in *receivables* generated by copyrights must also be perfected by filing in the Copyright Office. 66

It is important to note that the court in *Peregrine* failed to draw any distinction between registered and unregistered copyrights. This point is significant because documents relating to copyrights cannot be recorded in the Copyright Office unless the underlying work has been registered with the Copyright Office first.⁶⁷ The Copyright Office cannot accept a security agreement for recording unless it pertains to a registered copyright or a copyright for which a registration is pending. Moreover, the *Peregrine* decision did not consider what law governs *enforcement* of security interests in copyrights. Unlike Article 9 of the UCC, the Copyright Act does not address enforcement issues.

The bankruptcy court in *Official Unsecured Creditors' Comm. v. Zenith Productions, Inc. (In re AEG Acquisition Corp.)* cited *Peregrine* with approval in holding that security interests in the two foreign films at issue in that case were required to be perfected by recording a security agreement with the Copyright Office, rather than by filing a UCC-1 financing statement. The *AEG* court further stated that registration of the underlying copyright with the Copyright Office was also a condition for perfection. The court expressly avoided rendering

^{62 17} U.S.C. § 205(c) and (d).

⁶³ The grace period is two months for transfers executed outside the United States. 17 U.S.C. § 205(c).

^{64 116} B.R. 194 (C.D. Cal. 1990).

^{65 116} B.R. at 203. The court accurately noted that "filing with the Copyright Office can be much less convenient than filing under the UCC. This is because UCC filings are indexed by owner, while registration in the Copyright Office is by title or copyright registration number. *See* 17 U.S.C. § 205(c). This means that the recording of a security interest in a film library such as that owned by [the debtor] will involve dozens, sometimes hundreds, of individuals filings. Moreover, as the contents of the film library changes, the lienholder will be required to make a separate filing for each work added to or deleted from the library." Id. at 202 n.10. *See generally infra* parts III.B.1 and III.D.

^{66 116} B.R. at 207 and n.20.

⁶⁷ See 17 U.S.C. § 205(c).

⁶⁸ 127 B.R. 34 (C.D. Cal. 1991).

any opinion on the issue of whether recordation of a copyright mortgage would be valid if it were recorded *before* registration of the underlying copyright.⁶⁹

Unlike AEG, which essentially followed the Peregrine decision, In re Avalon Software, Inc. 70 significantly extended Peregrine by holding that recordation in the Copyright Office is required, not only to perfect security interests in registered copyrights and the proceeds thereof, but also to perfect security interests in "copyrightable"71 property and its proceeds. The court ruled that any copyrightable intellectual property which is entitled to be, but which has not yet been, registered in the Copyright Office must first be registered before a security interest in such property can be perfected, and that the burden is on the creditor to assure that this is done. The court also ruled that enhancements, offshoots or modifications to existing copyrighted (or copyrightable) works are subject to the same registration requirements. Without any analysis, the court in Avalon further held that the lender's failure to record its security interest in the Copyright Office caused the lender's security interest in related trademarks, service marks, knowhow, unpatented or uncopyrighted inventions, trade secrets and other general intangibles (including licenses, contract rights, permits, authorizations, user manuals and other documentation) to be unperfected.72

The holdings in *Peregrine* and *Avalon* concerning accounts receivable relating to copyrights have been

undercut somewhat, although not overruled, by the Ninth Circuit Court of Appeals' decision in *Broadcast Music, Inc. v. Hirsch, et al.*⁷³ In that case, the court ruled that an absolute and irrevocable assignment of a right to receive copyright royalties did not implicate any of the exclusive rights comprising a copyright⁷⁴ and was therefore not required to be recorded in the Copyright Office as a condition of its effectiveness. The court skirted the *Peregrine* holding by finding that the assignment at issue did not create a security interest. The *Hirsch* case is reviewed in more detail in part II.D.6(b) below.

The most recent decision regarding security interests in copyrights is Aerocon Engineering Inc. v. Silicon Valley Bank (In re World Auxiliary Power Co., et al.),75 a bankruptcy court case recently affirmed by the federal district court in the Northern District of California and now on appeal to the Ninth Circuit. The bankruptcy court in Aerocon limited the Peregrine and Avalon holdings with respect to *unregistered* copyrights, by ruling that federal preemption did not operate to prevent the secured creditor in the case from perfecting its security interest in unregistered copyrights by filing a UCC-1 financing statement with the California Secretary of State. The court reasoned that "the Peregrine court's analysis only works if the copyright was registered."76 The court held that, because the Copyright Act provides no means by which a security interest in an unregistered copyright may be perfected, the Copyright Act's recording provisions are not sufficiently comprehensive as applied to an unregistered copyright to preempt application of the UCC.77 Thus, the lender's state-level UCC filing was sufficient to perfect the lender's security interest in the unregistered copyright. The court nevertheless suggested that prudent lenders also record their security agreements in the Copyright Office, because a state-only filing could be invalidated if the unregistered copyright

PAGE 12 SUMMER 2001

⁶⁹ *Id.* at 41 n.8. In fact, it should be impossible to record a copyright mortgage against an unregistered copyright, because the mortgage document must identify the registered copyright to which the mortgage relates in order to provide constructive notice of the facts stated in the mortgage. *See* 17 U.S.C. § 205(c)(1).

^{70 209} B.R. 517 (Bankr. D. Ariz. 1997).

⁷¹ The *Avalon* court also noted that registration with the Copyright Office is not a condition of copyright protection. Therefore, in the court's view, attempting to characterize the intellectual work as something else, such as a trade secret, would not transform it into something in which a security interest could be perfected under state law alone, or otherwise alter the requirement that a security agreement in such property must be recorded in the Copyright Office. The *Avalon* court failed to recognize that much intellectual property falls under more than one legal category. See discussion of hybrid collateral *infra* part III.H.

 $^{72\,}$ The *Avalon* court did not discuss the fact that trademarks and service marks are subject to the Lanham Act, which establishes an entirely separate registration procedure, and that trade secrets are exclusively the province of state law.

^{73 104} F.3d 1163 (9th Cir. 1997).

⁷⁴ See infra text accompanying notes 88-89.

^{75 244} B.R. 149 (Bankr. N.D. Cal. 1999), aff'd 2000 U.S. Dist. LEXIS 20687 (N.D. Cal. July 13, 2000), *appeal docketed*, No. 00-16550 (9th Cir. _____, 2000).

⁷⁶ *Id.* at 152.

⁷⁷ *Id.* at 154.

were later registered and a competing security interest had been recorded in the Copyright Office.⁷⁸

(d) The Legacy of the <u>Peregrine</u> and Avalon Decisions.

The *Peregrine* and *Avalon* decisions have caused a host of practical problems in ordinary commercial financing transactions involving registered or unregistered copyrights and derivative rights. Those problems are reviewed in detail in part III below. Among other things, the decisions compel lenders to record their security agreements in the Copyright Office and to make additional recordings on a regular basis over the life of the loan for every new work or derivative product created by their borrowers. In addition, the decisions have forced lenders to require their borrowers to register unregistered copyrights prior to recordation of the security agreement. If the borrower does not do so, the lender faces substantial legal uncertainty as to the status of the work as security for the loan and may refuse to include it in the borrowing base⁷⁹ for the loan. Further, the decisions have created major new issues in financing accounts receivable derived, in whole or in part, from registered or unregistered copyrights.

Many of the problems resulting from the Peregrine and Avalon decisions can be corrected only through new federal legislation. An Act of Congress will be required to remove the antiquated references to "mortgage" and "hypothecation" from § 101 of the Copyright Act. The Ninth Circuit appeal in Aerocon, however, could provide limited relief with respect to *unregistered* copyrights. The bankruptcy court opinion in Aerocon constitutes significant new precedent, but standing alone it cannot and does not overrule Peregrine or Avalon. The Aerocon appeal presents the Ninth Circuit with an important opportunity to review the Peregrine and Avalon decisions critically, and at least with respect to unregistered copyrights, reinterpret the Copyright Act in a manner consistent with Article 9 of the UCC. Any published opinion issued by the Ninth Circuit in Aerocon will become controlling precedent within the circuit, and because there are no other federal appellate court cases on point, it will

also become the leading national authority on the subject of copyright financing.

4. Mask Works.

(a) Nature of Mask Works.

A mask work is a series of related images with a three-dimensional pattern present or removed from the layers of a semiconductor chip product. The owner of a mask work has the exclusive right to reproduce the design, and to import and distribute the semiconductor chips embodying it. Registration under the Semiconductor Act of 1984 (the "Semiconductor Act") constitutes prima facie evidence of ownership and validity of the mask work and is required in order to take advantage of the Semiconductor Act's protections against infringement.

(b) The Semiconductor Act of 1984.80

Section 903 of the Semiconductor Act does not specifically provide for the recording of security interests in mask works, but does provide for recording of transfers of all of the owner's rights in a mask work and of licenses of such rights. The legislative history of the Semiconductor Act indicates that the Copyright Office is to serve as the registry to record security agreements concerning mask works. Accordingly, Copyright Office recording is probably the exclusive means for perfection of a security interest in mask works. In the absence of controlling statutory or judicial authority, 2 many lenders may also elect to file a UCC-1 financing statement with the appropriate state office as a precaution.

Section 903(c)(2) of the Semiconductor Act provides priority rules, similar to the priority rules under the Copyright Act:

⁷⁸ *Id.* at 154 n.11. One important unanswered question is the legal status of a state-only filing once the borrower has submitted an *application* for copyright registration. It is uncertain whether a state UCC filing becomes ineffective at the time the federal application is submitted, or at the time when the application is approved by the Copyright Office and a registration number is issued – which may be months later.

^{79 &}quot;Borrowing base" is a term of art for the aggregate value of all of the borrower's personal property that is eligible to serve as collateral for the loan. Eligibility is determined by the lender, and one of the lender's primary criteria for eligibility is whether the lender can obtain a perfected security interest in the property.

⁸⁰ 17 U.S.C. §§ 901-914.

⁸¹ Section 903(c)(1) provides that any document pertaining to a mask work may be recorded in the Copyright Office.

⁸² To date, there have been no judicial decisions on perfection of security interests in mask works under the Semiconductor Act. Because of similarities between the Copyright Act and the Semiconductor Act, it is likely that *Peregrine* and other cases decided under the Copyright Act would serve as precedent in cases under the Semiconductor Act.

In any case in which conflicting transfers of the exclusive right in a mask work are made, the transfer first executed shall be void as against a subsequent transfer which is made for a valuable consideration and without notice of the first transfer, unless the first transfer is recorded in accordance with paragraph (1) [recordation] within three months after the date on which it is executed, but in no case later than the day before the date of such subsequent transfer.

Thus, for a transferee to obtain priority over later transfers, the transfer document must be recorded within three months after the date on which it is executed, but in no case later than the day before the date of a later transfer. Recordation with the Copyright Office is accomplished under the same regulations applicable to recordation of transfers of copyrights, and imparts constructive notice of the facts contained in the recorded document.

5. Trade Secrets.

A trade secret is information not generally known in industry, which has economic value and gives its owner a competitive advantage because of its secrecy. Perhaps the best known example of a trade secret is the formula for Coca-Cola. Other examples include unpatented inventions, designs, know-how, piece-part drawings, engineering specifications, unpatented manufacturing processes and techniques, recipes, computer programs, customer lists and marketing plans. To qualify for protection as a trade secret, the information must be the subject of reasonable efforts by the owner to maintain its secrecy.

Historically, trade secret protection has been the exclusive province of state law. There are no federal laws or regulations governing trade secrets as such.⁸⁴ Accordingly, for security interests in trade secrets, no question of federal preemption of the UCC should arise. Trade secrets are "general intangibles" under Article 9 of the UCC. Thus, a security interest in a trade secret is perfected by filing a UCC-1 financing statement in the applicable state filing office. No federal-level filing should be necessary.

The foregoing analysis seems clear enough, but unfortunately it has been muddied by the *Avalon* decision. Manufacturing companies often hold numerous trade secrets side-by-side with their registered patents or copyrights, and some of these trade secrets may be patentable or copyrightable under applicable federal law. The debtor-software company in *Avalon* apparently owned trade secrets that were either copyrightable or related to its copyrightable software. Citing no precedent whatsoever, the *Avalon* court ruled that a security interest in such trade secrets was *not* perfected by a state-level UCC-1 financing statement filing.⁸⁵

The Avalon court did not consider certain fundamental distinctions between copyrights and trade secrets - which are of key importance for computer software programs. Copyright protection is available only for the expression of an idea (e.g., the actual source and object codes for a software program, reduced to a tangible medium of expression such as paper or a computer disk). Trade secret law, however, protects the idea itself, so long as its confidentiality is preserved. The value of a copyright that constitutes a particular expression of a software program may represent only a fraction of the true value of the software, which lies in its unique utility and secrecy.86 The Avalon decision appears to assume that permitting security interests in trade secrets to be perfected by state-level filings only would constitute an end-run around the federal copyright laws. This view is incorrect because, among other reasons, copyright registration is elective under federal law.87 The fact that a trade secret may be eligible for registration under federal copyright law should not dictate the result that all security interests in trade secrets must be recorded in the Copyright Office.

6. Licenses, Royalties and Other Rights Related to Intellectual Property.

(a) State Law Foundations.

Licenses and sublicenses of intellectual property rights, royalties payable under such licenses or sublicens-

PAGE 14 SUMMER 2001

⁸³ See 37 C.F.R. § 211.2.

⁸⁴ For this reason, trade secret law is becoming a preferred means for companies to protect their intellectual property rights. See part III.F infra. Certain federal laws, however, do affect trade secrets. *See* 12 R. Milgrim, *Business Organizations, Milgrim on Trade Secrets,* § 12.02 (1995).

⁸⁵ *In re Avalon Software, Inc.,* 209 B.R. 517, 524 (Bankr. D. Ariz. 1997).

⁸⁶ The same issue exists in the case of piece-part drawings, manufacturing specifications and many other kinds of trade secrets. The value of the drawing or written specification itself is negligible in comparison with the value of what is depicted.

⁸⁷ See 17 U.S.C. § 408(a).

es, accounts receivable derived from the sale, lease or licensing of intellectual property, and other proceeds of intellectual property are all legal rights founded on state contract law. None of the federal intellectual property statutes regulates commercial licensing activities or the economic terms of contracts for sale, lease or licensing of intellectual property rights. For example, § 106 of the Copyright Act specifies several exclusive rights which accrue to the owner of a copyright, including the rights to reproduce the work, to prepare derivative works, to distribute copies, and to perform or display the work publicly.88 Section 301 of the Copyright Act states that the rights enumerated in § 106 are governed exclusively by the Copyright Act, and that "[n]othing in [the Copyright Act] annuls or limits any rights or remedies under the common law or statutes of any State with respect to . . . (3) activities violating legal or equitable rights that are not equivalent to any of the exclusive rights within the general scope of copyright as specified by section 106 "89 The Copyright Act thus disclaims any intent to regulate rights such as royalty rights that are outside the scope of § 106. The Lanham Act does not address licenses or royalties at all. The Patent Act addresses royalties only in the context of remedies for patent infringement, and addresses licensing only with respect to federally-owned patents. Federal courts presented with disputes concerning intellectual property licenses or royalties consistently hold that, although such disputes may be related to patents, copyrights or trademarks, such disputes do not "arise under" the federal intellectual property laws within the meaning of the statute conferring jurisdiction on the federal courts, 90 but rather are ordinary state contract-law matters.91

Because licenses, royalties, accounts receivable and other proceeds of intellectual property are not regulated by federal statutes, security interests in such rights, like security interests in trade secrets, should not be the subject of federal-level recording requirements. There should be no federal preemption of Article 9 of the UCC with respect to these rights. Licenses, royalties, accounts receivable and other proceeds of intellectual property are categorized either as "general intangibles" or as "accounts" under Article 9 of the UCC, and security interests in such rights should be perfected simply by filing a UCC-1 financing statement in the applicable state filing office. The *Peregrine* and *Avalon* decisions, however, ignored this logic. The perfection issues created by Avalon regarding copyright licenses are discussed below in part III.G.1. The perfection issues created by Peregrine and Avalon concerning royalties, accounts receivable and other proceeds of copyrights are addressed in the following subsection.

(b) Royalties and Other Receivables Related to Patents, Trademarks and Copyrights

In light of the federal court rulings that security interests in the underlying *patents and trademarks* are perfected by state UCC filings only, 92 there should be no doubt that security interests in royalties and other receivables derived from patents or trademarks can be perfected by state UCC filings alone. Although there are no judicial decisions on this point, there would be no principled basis for a court to hold otherwise. Difficulties arise, however, with regard to security interests in royalties and other receivables generated by *copyrights*. Both *Peregrine* and *Avalon* held that security interests in accounts receivable derived from copyrights must be perfected by recording a security agreement in the Copyright Office. 93 *Peregrine* and *Avalon* thereby creat-

in the text has been recognized where state law would conflict with federal patent policy. *See Lear, Inc. v. Adkins,* 395 U.S. 653, 673, 89 S.Ct. 1902, 1912-13, 23 L.Ed. 2d 610 (1969); *Everex Systems, Inc. v. Cadtrak Corp. (In re CFLC, Inc.),* 89 F.3d 673, 677-79 (9th Cir. 1996).

⁸⁸ See 17 U.S.C. § 106.

^{89 17} U.S.C. § 301(a) and (b).

⁹⁰ See 28 U.S.C. § 1338(a).

⁹¹ See Aronson v. Quick Point Pencil Co., 440 U.S. 257, 266, 59 L.Ed.2d 296, 99 S.Ct. 1096 (1979) (Patent Act did not preempt state contract law applicable to a royalty contract); Kewanee Oil Co. v. Bicron Corp., 416 U.S. 470, 492-93, 40 L.Ed.2d 315, 94 S.Ct. 1879 (1974) (state trade secret law not preempted by the Patent Act); ProCD, Inc. v. Zeidenberg, et al., 86 F.3d 1447, 1454 (7th Cir. 1996) ("shrinkwrap" copyright licenses governed by state contract law and the UCC); Topolos v. Caldewey, 698 F.2d 991, 993 (9th Cir. 1983) (contract claim does not "arise under" Copyright Act merely because subject of contract happens to be a copyright); T. B. Harms Co. v. Eliscu, 339 F.2d 823, 828 (2nd Cir. 1964), cert. denied, 381 U.S. 915 (1965) (copyright ownership dispute did not "arise under" the Copyright Act). A limited exception to the general rule stated

⁹² E.g., Moldo v. Matsco (In re Cybernetic Services, Inc.),252 F.3d 1039 (9th Cir. 2001) (patents); In re Together Development Corp., 227 B.R. 439 (Bankr. D.Mass. 1998) (trademarks). See generally supra parts II.D.1(b) and II.D.2(c).

⁹³ National Peregrine Inc. v. Capitol Fed. Savings and Loan Assn. of Denver (In re Peregrine Entertainment Ltd.), 116 B.R. 194 (C.D. Cal. 1990); In re Avalon Software, Inc. 209 B.R. 517 (Bankr. D. Ariz. 1997). Avalon included "licenses" and "proceeds from

ed significant uncertainties regarding perfection of security interests in copyright-related royalties and other receivables.

The extension of federal law by the Peregrine and Avalon courts to security interests in accounts receivable "relating to" copyrights was made with virtually no analysis and without regard for the numerous federal court decisions94 holding that copyright royalties are not governed by the Copyright Act. The Peregrine and Avalon holdings with respect to copyright-related accounts receivable are therefore highly dubious. Both courts seemed to assume that accounts receivable from the sale or licensing of copyrighted works are merely extensions of the underlying copyrights, and are therefore subject to the same federal preemption analysis. Accounts receivable, however, constitute a distinct asset class under business accounting principles and an independent category of collateral under the UCC. Moreover, as noted above, accounts receivable are not included on the list of exclusive rights of copyright ownership set forth in § 106 of the Copyright Act. Therefore, the federal preemption analysis applicable to copyrights should not apply to accounts receivable, even if the accounts receivable arise as a result of a transfer of ownership of copyrights, rather than from licensing activities. No proprietary rights in the copyright itself are implicated.

The *Peregrine* and *Avalon* decisions also conflict with commercial law policy. UCC requirements for perfection of security interests in accounts receivable do not vary depending on the source of the receivable. There is no reason why perfection requirements for receivables representing copyright proceeds should differ from the perfection requirements for receivables representing proceeds of other types of collateral. Furthermore, these decisions conflict with Copyright Act policy to the extent that they impede lending transactions based on copyright royalties. One of the primary objectives of the Copyright Act is to encourage the commercial use and

sales" of copyrighted and non-copyrighted software in its list of collateral which was unperfected because the security agreement had not been recorded in the Copyright Office.

development of copyrights. Federal and state law should facilitate lending on copyright royalties, because this increases the value of the underlying copyright and provides incentives for creation of additional works. 96

A recent Ninth Circuit case has rejected the Peregrine reasoning as it relates to interests of third parties in royalties and, at least implicitly, other rights to payment arising out of copyrights. Broadcast Music, Inc. v. Hirsch⁶⁷ reversed a district court decision that had relied heavily on Peregrine, and held that an assignment of copyright royalties for the purpose of satisfying a preexisting debt is not a "transfer of copyright ownership" as defined in § 101 of the Copyright Act, because it was not "an assignment, transfer or mortgage of the copyright or any of the exclusive rights comprised in a copyright."98 Furthermore, it was not a "document pertaining to a copyright" within the meaning of § 205(a) of the Copyright Act, because "[a]ssignments of interests in royalties have no relationship to the existence, scope, duration or identification of a copyright, nor to 'rights under a copyright'."99 The Copyright Act recording requirements were therefore inapplicable and did not preempt state law. The assignment of royalties at issue in Hirsch had been perfected under state law by irrevocable payment instructions from the assignor prior to the attachment of an IRS lien. The assignees' claims to the copyright royalties were therefore superior to the IRS lien, notwithstanding that the assignment had not been recorded in the Copyright Office.

The Ninth Circuit in *Hirsch* distinguished *Peregrine* by stating that an outright assignment of a right to receive royalties for the purpose of satisfying a debt does not involve "an assignment" of a security interest. "Thus, the rationale for recordation underlying the *Peregrine* case – to provide notice to prospective creditors or purchasers of the copyright who may rely to their detriment on the appearance of ownership or rights under a copyright – is inapposite." Nonetheless, *Hirsch* did

PAGE 16 SUMMER 2001

⁹⁴ See supra note 91. "[W]e have consistently held that an action does not arise under the federal copyright laws merely because its subject matter happens to involve a copyright." Effects Assoc., Inc. v. Cohen, et al., 817 F.2d 72, 73 (9th Cir. 1987).

⁹⁵ Haemmerli, 96 Colum. L.Rev. at 1692.

⁹⁶ *Id.* at 1686.

^{97 104} F.3d 1163 (9th Cir. 1997).

⁹⁸ *Id.* at 1166.

⁹⁹ *Id.* The court also held that no security interests in the underlying copyrights were created, notwithstanding contract language to the contrary, because none of the parties to the transfer intended that result. *Id.* at 1167.

¹⁰⁰ Id. at 1166.

not overrule *Peregrine*. Amendments to the federal intellectual property laws are therefore needed to clarify that security interests in royalties, receivables and other proceeds of intellectual property can be perfected by state-level UCC-1 financing statement filings only.

III. "Real World" Problems in Commercial Financing Transactions.

A. Introduction.

As a general rule, the more certain and predictable are a lender's rights in its loan collateral, the more favorable are the loan terms that the lender can offer the borrower. Conversely, to the extent there are risks and uncertainties associated with a lender's collateral position, the borrower's interest rate and other borrowing costs will increase and the amount available to be borrowed may decrease. In some cases, financing may not be available at all. The present uncertainties in the state of the law concerning security interests in intellectual property are causing delays and increasing the costs of ordinary commercial lending transactions, and are requiring lenders to alter their normal lending practices in ways that are disadvantageous to borrowers. Peregrine and Avalon decisions have created significant new risks for lenders to companies with valuable intellectual property rights, and new burdens for all parties in lending transactions involving such rights. Some of the more significant practical problems are the following:

- The impossibility of obtaining current search reports of PTO or Copyright Office records, and the additional expense and cumbersome procedures for recording documents in those offices.
- The absence of an efficient and cost-effective mechanism for lenders to perfect "blanket" security interests in multiple intellectual property rights.
- The absence of an efficient and cost-effective mechanism for lenders to perfect security interests in intellectual property rights acquired by the borrower after the loan closing.
- The additional administrative burden on the PTO and the Copyright Office resulting from the need for multiple, duplicative recordings of security agreements covering after-acquired intellectual property, and recordings of security agreements covering intellectual property rights (such as non-exclusive licenses) which are not otherwise regulated by these agencies.

- The need for borrowers to register, and thereby publicly disclose, confidential *unregistered* intellectual property rights in order to qualify such rights for inclusion in the borrowing base for the loan.
- The need to make federal-level recordings of security agreements covering derivative contract rights, such as licenses, royalties, receivables and other proceeds of intellectual property, which are not otherwise regulated by federal law.
- The need to record security agreements covering embedded software and other hybrid collateral, and, to the extent that security interests in certain valuable components are not perfected, the potential need to determine and allocate the value of the unperfected component upon a borrower's bankruptcy.

Each of these problem areas is reviewed in more detail below.

B. PTO and Copyright Office Records.

1. Obtaining Search Reports.

As a condition precedent in secured loan transactions, lenders typically require search reports of state UCC records to verify that no previous UCC-1 financing statements have been filed against the borrower with respect to the proposed loan collateral. The lender must confirm that the property included in the borrowing base is not subject to any pre-existing liens or security interests that could interfere with the lender's ability to realize the entire economic value of the collateral. If the collateral includes intellectual property, the lender's search should also encompass PTO or Copyright Office records. Ordinarily, a lender will not fund the loan until all necessary search reports are received and the results have been approved.

State UCC records are indexed by the names of the borrower and the secured party, not according to a description of the property securing the loan. Only one brief UCC-1 financing statement filing is normally required for a lender to perfect a "blanket" or "global" security interest covering many different items of property owned by the same borrower. The personal property collateral may be described generically. UCC

¹⁰¹ There are exceptions, as enumerated in U.C.C. § 9-109 and in Chapter 3 of Article 9, for special types of collateral such as motor vehicles and aircraft.

searches are quickly and easily conducted using the borrower's name alone. A typical UCC search report will list all UCC-1 financing statements filed against the borrower who is the subject of the report. It is possible to obtain current, uncertified search reports on very short notice from independent search companies, and current search reports certified to be accurate by the Secretary of State (or other state official maintaining the UCC records repository) are usually available within a reasonable period of time.

In comparison, federal patent, trademark and copyright ownership records are maintained in the PTO or the Copyright Office, as the case may be, principally according to the title of the work, its registration number and the name of the inventor or initial registrant. While both offices also maintain records of assignments (including security agreements), it may be difficult to obtain information concerning subsequent assignments of the work without the registration number of the work in question. PTO or Copyright Office search reports usually take the form of a "chain of title" to a particular work, beginning with the title and registration number of the work and showing all documents recorded with respect to that work. Search reports by the name of a borrower may be obtained, but may not disclose all information relevant to a prospective lender. An additional search request must be made and additional time allowed if the lender wishes to obtain and review copies of recorded documents. Furthermore, the PTO and Copyright Office themselves do not perform searches for the general public; therefore, no certified search reports are available from those offices. 102 All PTO and Copyright Office searches are performed by independent search companies based in the Washington, D.C. area.

The most serious deficiency associated with PTO and Copyright Office searches is that the reports generated are significantly out-of-date. The Copyright Office receives approximately one million documents each year, and currently, there is a delay of about *ten to twelve months* after a document is delivered to the Copyright Office before the document is microfilmed and catalogued in Copyright Office records. As a result, although a records search can be performed by a search company within one or two days, the search report itself will be almost one year out-of-date. The PTO is also

behind schedule in its document processing, although not to the same extent as the Copyright Office. Search reports of PTO records are typically four to six months out-of-date. These deficiencies are aggravated by the statutory "grace periods" provided for recording signed transfer documents. As a consequence of these difficulties, many lenders are compelled to rely exclusively on the borrower's internal records, which may or may not be accurate, for information concerning the status of the borrower's intellectual property rights.

2. Recording Documents in the PTO and the Copyright Office.

An additional issue is that PTO and Copyright Office recordings are costly and time-consuming to prepare. Each office requires two-page cover sheets (and continuation sheets as necessary) to be completed and signed for each document submitted for recording. The PTO charges \$40.00 *per patent* as a recording fee for each document relating to one or more patents.¹⁰⁴ Recording a patent security agreement covering 10 patents will therefore cost \$400.00, plus the fees and expenses for cover-sheet preparation. In contrast, the typical filing fee charged by state filing offices for a UCC-1 financing statement is \$10.00 or less (although fees vary from state to state), and a one-page UCC-1 financing statement may cover many different types of personal property collateral owned by a single borrower.

C. Multiple Intellectual Property Rights.

Ownership of intellectual property rights in multiples is the rule, rather than the exception, among technology companies (such as manufacturers using patented technology and software developers) and companies in the media, entertainment and publishing industries. While only a few copyrights may be involved in a motion picture financing, the vast majority of secured loan transactions with technology companies involve numerous intellectual property rights. As discussed in part III.H below, some types of collateral may implicate more than one category of intellectual property at the

PAGE 18 SUMMER 2001

 $^{^{102}}$ See Copyright Office Circular 22, "How to Investigate the Copyright Status of a Work."

¹⁰³ See supra parts II.D.1(c), II.D.2(b)(1) and II.D.3(b) (three months for patents and trademarks, one month for copyrights).

¹⁰⁴ For trademark recordings, the PTO charges \$40.00 for the first trademark and \$25.00 for each additional trademark referenced in a single document. The Copyright Office charges \$50.00 for the first copyright referenced in a document, and an additional \$15.00 for each additional group of up to 10 titles referenced in the same document.

same time. Under present law, there is no cost-efficient mechanism for a borrower to grant a lender an enforceable security interest in "all of my patents" or "all of my copyrights" because of the need to identify separately each patent, trademark and copyright in the loan documentation. Moreover, the existence of separate recording procedures in the PTO and the Copyright Office will require lenders to prepare and record separate patent, trademark and copyright security agreements in the same loan transaction. Preparation of the cover sheets may also be time-consuming, because of the need to list each work by registration number. In one recent transaction, the lender was faced with a borrower that owned a library of over 10,000 music copyrights. The borrower's costs for preparation of the cover sheets and recordation of the lender's copyright security agreement were enormous, and the loan closing was delayed because of the significant amount of time required to complete the task.

D. After-Acquired Intellectual Property Rights.

Another set of problems arises when a borrower creates new or derivative works or upgrades to existing intellectual property collateral after the loan closing. In order to assure that its security interests remain perfected in such "after-acquired" works, the lender will be required to monitor the borrower's activities closely and make separate new federal recordings for each new item of intellectual property collateral and each modification, add-on or enhancement.¹⁰⁵ One recent loan transaction involved the developer of a series of component software programs which were licensed to other software developers and incorporated into larger operating systems. The component programs were constantly being revised and upgraded, and none of the programs or the upgrades were registered with the Copyright Office. The borrower and lender ultimately developed a procedure for quarterly review and federal registration of the borrower's new works and upgrades. While the procedure was cumbersome and expensive, there was no other reasonable alternative and the borrower bore the costs. For some

smaller companies, however, the increased loan administration costs may be prohibitive.

The issue presented by design changes and upgrades is not limited to software collateral. In another recent financing, the lender desired to take a security interest in the accounts receivable of a borrower who was a manufacturer of hotel draperies. The drapery manufacturer developed and used fabric patterns that changed regularly. In view of the *Peregrine* and *Avalon* cases, the lender was compelled to require the borrower to register all of its fabric patterns with the Copyright Office, including all pattern changes and modifications, before the lender could be assured that it had an enforceable security interest in the borrower's accounts receivable.

Ongoing registration of newly developed or "afteracquired" works is expensive and cumbersome for borrowers and lenders to accomplish. The Avalon case compels lenders to monitor their borrowers' development of "copyrightable" material, to require the borrowers to register new material promptly with the Copyright Office, and to amend their Copyright Office filings to add all newly copyrighted material. As a result, a lender is forced to intrude on the borrower's operations in a way that would normally not be necessary. In addition, these requirements increase the costs of administration of the loan facility and necessitate a level of technological knowledge and expertise that lenders may not possess. This increased cost of loan administration may be sufficient to raise a lender's cost of capital to a level that makes the loan transaction uneconomic.

For well over 50 years in the United States, under the UCC and under the patchwork of commercial statutes which predated the UCC, lenders have been able to secure "floating liens" on pools of collateral, such as inventory and accounts receivable. 106 Such "floating" or "blanket" liens, which cover multiple property rights and property rights arising after execution of the security agreement, are a normal and customary feature of working capital loans. Under the UCC, "floating" liens can be perfected easily, with only a single UCC filing. Because the federal intellectual property laws were not designed to regulate secured lending transactions, the federal laws make no provision for "floating" lien filings, and hence force lenders to make multiple, serial record-

¹⁰⁵ In contrast, under the UCC, personal property acquired by the borrower after the loan closing can be made subject to the lender's security interest in advance, by a general reference in the UCC-1 financing statement to "after-acquired" property. No subsequent UCC filings are necessary, and there is no need for the lender to monitor the borrower's future property acquisitions. *See infra* text accompanying note 106.

¹⁰⁶ See generally Official Comment 2 to U.C.C. § 9-204; Official Comment 1 to U.C.C. § 9-205.

ings in the PTO or the Copyright Office, at substantial additional cost to the borrower.

E. Administrative Burdens on the PTO and the Copyright Office.

As noted in part III.B above, there are significant delays at both the PTO and the Copyright Office in processing registrations and document recordations. The purpose and historic function of each office are to provide and maintain registration systems for *ownership* interests in intellectual property. Requiring numerous duplicative recordings of security agreements for the same borrower increases the administrative burden on the PTO and the Copyright Office by increasing the volume of paperwork that these offices must process. These extra filings hinder the ability of the PTO and the Copyright Office to process patent, trademark and copyright applications promptly, and thus impair their primary function of maintaining *ownership* records.

Transfers of *non-proprietary* interests in intellectual property rights, such as non-exclusive licenses, should not need to be recorded in the Copyright Office or the PTO in order to permit lenders to enforce security interests in those rights against parties (such as bankruptcy trustees) who are not actual purchasers of ownership rights in the licensor's intellectual property. As discussed in part III.G.1 below, the Copyright Act does not require documents creating or transferring non-exclusive copyright licenses (such as the so-called "shrink-wrap" licenses packaged with mass-marketed computer software) to be recorded in the Copyright Office. Yet the Avalon case, by failing to distinguish between exclusive and nonexclusive licenses, appears to require that all *non-exclusive* licenses of copyrights be recorded in order for a lender to perfect a security interest in the licensee's accounts receivable.

F. Unregistered Intellectual Property Rights.

In many commercial credit facilities for technology companies, the lender desires to secure loan advances with accounts receivable derived from unregistered but "copyrightable" intellectual property rights. As discussed in part II.D.3 above, the *Avalon* case held that security interests in the proceeds of unregistered but copyrightable intellectual property cannot be perfected unless the underlying copyrightable property is registered with the Copyright Office first. This registration requirement often conflicts directly with the borrower's

business plan.

Many technology companies are reluctant to register uncopyrighted works, based on well-founded concerns that public disclosure in Copyright Office records may shorten a product's economic life by enabling competitors to replicate it through reverse engineering. Although the Copyright Office has implemented procedures intended to protect confidential information, such as redacting lines of code in software programs submitted for copyright registration, most software developers prefer not to make any aspect of their work product available for public view. Instead, they prefer to rely on trade secret protection and confidentiality agreements. 107 This is particularly true for software companies engaged in rapid development of new programs and continual upgrades of older programs. For these companies, the limited additional rights obtained by registration do not outweigh the expense and distraction of efforts to register each new iteration of a software program. Moreover, because of the nine- to ten-month delays at the Copyright Office, some works are obsolete by the time registration is effective. The company's affirmative business strategy not to register its work is at odds with the lender's need to obtain a perfected security interest in the unregistered work and the accounts receivable derived from it.

One recent financing involved a borrower who was the developer of the leading software program used by many small and medium-sized banks to run substantial parts of their banking operations. The software was proprietary and highly confidential. The borrower did not want to register the software with the Copyright Office, but the lender insisted on registration as a condition of making the loan. Finally, a complex procedure was worked out with the Copyright Office to redact portions of the software as part of the registration process. The costs of perfecting the lender's security interest in the software ultimately exceeded all other costs of the loan transaction.

In another proposed lending transaction, the borrower had invested tens of millions of dollars in development of an extremely sophisticated motor vehicle

PAGE 20 SUMMER 2001

¹⁰⁷ Manufacturing companies have identical concerns with respect to piece-part drawings and records of manufacturing processes, and similarly prefer to rely on trade secret law and confidentiality agreements, rather than copyright registration, for protection.

traffic control system used by toll road authorities to collect tolls, to monitor and report traffic conditions, to facilitate the use of transponders attached to vehicles in special lanes, and to process traffic citations. The software was still in development, and the borrower, for justifiable business reasons, did not want to register the code, even if portions of it were redacted from the Copyright Office application. Without registration of the software code, however, the lender was unwilling to fund the loan.

As discussed in part II.D.3 above, the *Aerocon* holding that a security interest in an unregistered copyright and its proceeds can be perfected solely by a state-level UCC filing, without need to register the copyright or record a security agreement in the Copyright Office, is directly contrary to the Avalon decision. Aerocon has diluted the precedential force of the Avalon decision to some extent, 108 unless and until Aerocon is affirmed by the Ninth Circuit, Avalon remains potentially useful as authority for a bankruptcy trustee seeking to avoid a security interest in an unregistered copyright. The Aerocon decision is better reasoned, but neither case constitutes binding precedent in any future bankruptcy proceeding. Thus, at present, prudent lenders cannot ignore Avalon, and in the absence of corrective amendments to the Copyright Act or a dispositive ruling from the Ninth Circuit in the Aerocon appeal, lenders must continue to require their borrowers to register copyrightable intellectual property rights with the Copyright Office as a condition of making the loan.

G. Intellectual Property Licenses, Royalties and Accounts Receivable.

1. Exclusive and Non-Exclusive Licenses.

The registration requirement discussed in part III.F above becomes even more complex if the borrower is not the owner of the copyrightable property at issue, but instead is only a *licensee* under a license agreement with a third-party owner-licensor. *Avalon* held that a security interest in the borrower's rights as a licensee of an unregistered copyright was unperfected because the underlying copyright had not been registered with the Copyright Office. ¹⁰⁹ This implies that a lender must

attempt to require the borrower's *licensor* to register the copyrightable property as a condition of the loan. As a practical matter, however, this will be impossible. The borrower typically has no leverage or control over the licensor after the license agreement is entered into, and the lender has no contractual relationship with the licensor, so neither the borrower nor the lender can force the licensor to register the licensed property.

Avalon also indicates that the license agreement *itself* must be recorded in the Copyright Office, along with the security agreement that creates the security interest in the licensee's rights. This requirement is inconsistent with the language of § 205(a) of the Copyright Act, under which a license agreement (as a "document pertaining to" a copyright) is permitted, but not required, to be recorded in the Copyright Office. Any additional recording requirements create additional expense and delay for the parties to a lending transaction, and this requirement adds yet another complication if the license is *non-exclusive*.

A non-exclusive license is a license that can be granted over and over again, without diminishing the retained rights of the licensor in the intellectual work. Nonexclusive licenses are expressly excluded from the definition of a "transfer of copyright ownership" under the Copyright Act.¹¹¹ A classic example of a non-exclusive license is the license held by almost every personal computer owner to use Microsoft's Windows operating system. In Harris v. Emus Records Corp. 112 the Ninth Circuit Court of Appeals, applying established patent law to the field of copyrights, noted that a non-exclusive license has been characterized as an agreement by the licensor not to sue the licensee for infringement and that such a license is not an assignment of proprietary rights. The court held that a non-exclusive copyright license does not create or transfer an interest in the underlying copyright. 113

¹⁰⁸ See supra text accompanying notes 75-78. Aerocon does not obviate the need for protective recordings in the Copyright Office to safeguard the lender if the unregistered copyright is later registered.

^{109 209} B.R. at 523.

 $^{110\,}$ 17 U.S.C. § 205(a). See supra text accompanying note 58. See also 37 C.F.R. § 201.4(a)(2).

^{111 17} U.S.C. § 101.

^{112 734} F.2d 1329 (9th Cir. 1984).

¹¹³ *Id.* at 1334. Following its holding in *Harris*, the Ninth Circuit in *Everex Systems, Inc. v. Cadtrak Corp. (In re CFLC, Inc.)*, 89 F.3d 673, 679 (9th Cir. 1996), concluded that a non-exclusive licensee of a patent has only a personal and not a proprietary inter-

Harris and similar cases have clarified that a non-exclusive license does not convey any property interest in the copyright itself to the licensee and thus does not constitute a "transfer" that is required by the Copyright Act to be recorded in the Copyright Office to establish the licensee's rights. In theory, the Copyright Office could reject any transfer document for a non-exclusive license. If it is not necessary to record non-exclusive licenses in the Copyright Office, it follows that it should not be necessary to make a Copyright Office recording for a security interest in the licensee's rights under a non-exclusive license.

Another source of confusion relates to the potential degrees of exclusivity or non-exclusivity of copyright licenses. It is uncertain just how exclusive a license must be before it constitutes an "assignment" under *Harris* and therefore a transfer of an ownership interest in the underlying copyright under the Copyright Act, and as such, required to be recorded. Neither *Peregrine* nor *Avalon* acknowledged or discussed the *Harris* holding or made any distinction at all between exclusive and non-exclusive copyright licenses.

If Avalon's holding prevails, a lender's due diligence task becomes insurmountable. Before extending credit to a business enterprise, the lender must first identify all of the borrower's software licenses, which will range from commonplace mass market licenses (such as Microsoft Windows, Word and Excel) to licenses for either standardized or customized business applications and systems-integration software. The lender must then attempt to determine whether or not the licensed software is copyrightable and, if so, whether or not the thirdparty licensor has registered the copyright on that particular version of the software which has been licensed to the borrower. The borrower and the lender must then try to have the third-party licensor register the copyright, which, as noted above, will usually prove fruitless.

Under ordinary state contract law principles, without the licensor's prior consent, the creation of a security interest in the licensee's rights under an exclusive license with a non-assignability provision or under a

est in the intellectual work. Non-exclusive patent licenses are therefore assignable only with the consent of the licensor. In *Everex*, this meant that the license could not be assumed and assigned by the debtor-in-possession in a bankruptcy proceeding. *See also Perlman v. Catapult Entertainment, Inc.* (In re Catapult Entertainment, Inc.), 165 F.3d 747 (9th Cir. 1999).

non-exclusive license (regardless of the presence of a non-assignability provision)114 will result in a breach of the license agreement. One of the policies of Revised Article 9 is to facilitate (to the extent possible within the framework of state law) commercial financing of contract rights derived from patents, copyrights and trademarks. Revised Article 9 therefore renders non-assignability clauses in intellectual property license agreements ineffective to the extent they impair the creation, attachment or perfection of a security interest.¹¹⁵ The purpose of this provision is to obviate the need for borrowerlicensees to obtain consent from their licensors before entering into a commercial financing transaction. 116 The Avalon decision, by requiring borrower-licensees to attempt to have their licensors register the licensed copyright, is contrary to the policies of Revised Article 9.

2. Royalties and Accounts Receivable.

As discussed in part II.D.6 above, the *Peregrine* and Avalon decisions require security interests in royalties, accounts receivable and other proceeds of copyrights to be perfected by filing security agreements in the Copyright Office. These new recording requirements have resulted in significantly increased transaction costs, delays and legal uncertainties, all of which adversely affect the loan terms that lenders are able to offer their borrowers in working capital loan transactions. decisions failed to recognize the economic significance to lenders of liquid assets such as accounts receivable, royalties and license payments. Lenders typically do not rely directly, or base the value of loans to their borrowers, on the copyright itself, but instead on the revenue stream generated by the copyrighted work. Because these derivative rights are essentially contract rights, which are not regulated by the Copyright Act, security interests in such rights should not be subject to Copyright Act recording requirements.

For the same reason, security interests in accounts receivable and other proceeds of copyright *licenses* should not be subjected to the *Peregrine-Avalon* recordation requirements. Perfection of security interests in accounts receivable derived from either exclusive or non-exclusive

PAGE 22 SUMMER 2001

¹¹⁴ See supra note 113.

¹¹⁵ See Revised U.C.C. § 9-408(a).

 $^{^{116}}$ Consent of the licensor is still required before a lender can foreclose on, or otherwise utilize, the borrower's rights under the license.

licenses should be governed solely by the UCC, and not by the Copyright Act. A lender to a licensee using the licensed copyright in its manufacturing process should be able to perfect a security interest in the licensee's inventory and accounts receivable simply by filing a UCC-1 financing statement in the applicable state office.

H. Hybrid Collateral.

1. Embedded Software.

Many manufactured products such as automated teller machines and other sophisticated machinery and electronic equipment contain embedded software, which may or may not be registered with the Copyright Office. The software may be proprietary, or it may be licensed from another vendor. This presents another practical difficulty for a manufacturer wishing to finance its inventory and accounts receivable. In order to retain priority in any future bankruptcy proceeding, a lender must require the borrower to cause the embedded software to be registered and any related copyright license recorded in the Copyright Office, in addition to recording the lender's security agreement there. Otherwise, the bankruptcy trustee (or debtor-in-possession) could assert that the lender has no security interest in the embedded software, nor in that portion of the accounts receivable allocable to the software. The trustee might further argue that the equipment is worthless without the embedded software, and therefore all accounts receivable derived from the sale of the equipment are free and clear of the lender's security interest There are no reported court decisions involving embedded software which might provide some guidance to a lender in these circumstances. A prudent lender will therefore not give full loan value to a borrower's inventory of products with embedded software or accounts receivable as long as the inventory is subject to this risk.

Revised Article 9 seeks to address the issue of embedded software by expanding the definition of "goods" to include "a computer program embedded in goods . . . if (i) the program is associated with the goods in such a manner that it customarily is considered part of the goods, or (ii) by becoming the owner of the goods, a person acquires a right to use the program in connection with the goods." In the view of the drafters, software

on semiconductor chips that run automobile braking or climate control systems would be considered Apart of" the automobile under this definition. Under Revised Article 9, software which is not "part of" the goods within this definition constitutes a "general intangible" 118 and is subject to different UCC rules for perfection of security interests. The new Revised Article 9 provisions concerning software will not supplant the Copyright Act, however. The Copyright Act remains in force and will continue to preempt Revised Article 9 under applicable federal preemption principles. While the new Revised Article 9 provisions concerning embedded software certainly will be helpful if the Copyright Act is amended to address the problems outlined in this paper, they will not eliminate the need under current law for federal recordation of copyright security interests to the extent that federal law preempts Revised Article 9.

2. Other Hybrid Collateral; Allocation Issues: Transformation Issues

Embedded software is but one example of hybrid collateral in which one or more types of intellectual property are "bundled" with other property rights in an integrated product. Another example is product packaging (so-called "trade dress"). Historically, product labels and packaging have been governed by trademark law, but in Quality King Distributors, Inc. v. L'Anza Research Int'l, Inc., 119 the U.S. Supreme Court upheld application of the Copyright Act to hair care product labels that had been registered as copyrights. The Quality King decision introduced substantial legal uncertainty to the traditional area of inventory financing where the inventory collateral has "copyrightable" packaging. Inventory financing is an extremely common method by which wholesale and retail businesses obtain credit, and until Quality King, there was no doubt that ordinary inventory financing transactions were governed exclusively by Article 9 of the UCC. It is now uncertain whether lenders must also record inventory security agreements with the Copyright Office - and whether borrowers must first register such

 $^{^{117}}$ Revised U.C.C. \S 9-102(a)(44). The definition excludes the medium in which the program is embedded.

¹¹⁸ Revised U.C.C. § 9-102(a)(42). Determining whether software is "part of" particular goods will undoubtedly be difficult in some cases. In close cases, a prudent lender would treat the software both as "part of" the goods and as a separate "general intangible" and perfect its security interest accordingly.

 $^{119\,}$ 523 U.S. 135, 140 L.Ed.2d 254, 118 S.Ct. 1125 (1998). *Quality King* did not involve security interests, but rather marketing rights to certain imported goods.

packaging with the Copyright Office in order to enable the lender make Copyright Office recordings. In the absence of federal-level registrations and recordings, Quality King provides the foundation for an argument that the lender does not have a perfected security interest in the packaging. In the event of the borrower's bankruptcy, the trustee may assert that the inventory has little or no value without the packaging, and that a disproportionately high value should be allocated to the packaging in which the lender is not perfected. The asserted allocation may have little or no relationship to the actual cost of the packaging. The trustee may also assert that the proceeds of sale of the inventory should be allocated in the same manner. In Avalon, the bankruptcy court held that a full trial was necessary to determine how to allocate the value of the perfected and unperfected portions of the collateral.120

Software itself may encompass several different categories of intellectual property and other property rights. While the source and object codes and documentation are the subject of copyright law, software content may be patentable.¹²¹ Software programs and databases may include trade secrets. The media on which software is recorded, such as discs, drives or tape, may constitute inventory or equipment. Finally, software licenses and other royalty and use agreements will give rise to contract rights. Perfecting security interests in software and other integrated products requires the lender to attempt to subdivide, artificially, the bundle of legal rights associated with such products and take multiple and potentially duplicative actions to accomplish the task. This interdisciplinary characteristic of software has been overlooked by all of the courts and many of the lobbyists and commentators addressing issues concerning security interests in intellectual property rights.

Other types of intellectual property can change form and legal character. For example, trade secrets can become patents, and common law or state-registered trademarks can become federally registered trademarks. Even trade dress protection under the Lanham Act can become the subject of a design patent. As long as security interests in all of the various forms of intellectual property can be perfected under state law, such transformations do not prejudice the secured party. If federal-level recordings are required, however, and the work qualifies under more than one federal intellectual property regime, duplicative federal recordings must be made under each applicable federal registration system. Moreover, the status of the lender's security interest in the predecessor category of intellectual property is uncertain.

IV. Prior Attempts at Legislative Reform.

In response to the decisions in *Peregrine* and *Avalon*, both the American Bar Association (through a joint task force of its Business Law and Intellectual Property Law Sections) ("ABA") and the Commercial Finance Association ("CFA")123 proposed federal legislative initiatives to address the issues outlined above. The ABA proposed a comprehensive new federal statute (the Federal Intellectual Property Security Act, referred to as "FIPSA"), intended to establish new federal-level filing systems indexed according to borrowers' names for security interests in intellectual property. Among other things, under FIPSA, a federal-level filing would govern the priority of a secured party as against bona fide purchasers of intellectual property, while state-level filings under the UCC would control the priority of a secured party as against other secured parties and lien creditors (including bankruptcy trustees).

The legislative solution offered by the CFA was more narrowly targeted. The CFA proposed simply to amend § 205 of the Copyright Act to provide that the

PAGE 24 SUMMER 2001

^{120 209} B.R. at 524.

¹²¹ The PTO issued 13,900 software patents in 1999, including the infamous "one-click" patent number 5,960,411, awarded to amazon.com for a customer order feature of its website. Philip E. Ross, *Patently Absurd, Technology and Gamesmanship Have Overwhelmed the U.S. Patent Office. How to Fix it?, Forbes, May 29, 2000, at 180, 182.* The validity of the "one-click" patent has since been challenged by one of amazon.com's competitors. See *Amazon.com, Inc. v. Barnesandnoble.com, Inc., 239 F.3d 1343* (Fed. Cir. 2001).

¹²² Design patents are granted under 35 U.S.C. § 171 for 14 years to protect new and original features and configurations for articles of manufacture that are nonfunctional and ornamental. The purpose is to promote the "decorative arts". Section 43(a) of the Lanham Act has been applied broadly to protect trade dress and product and packaging design. See *Two Pesos, Inc. v. Taco Cabana, Inc.*, 505 U.S. 763, 112 S. Ct. 2753, 120 L.Ed.2d 615 (1992) (protection of overall decor, layout, menu design and style of restaurant).

 $^{^{123}}$ The Commercial Finance Association is the national trade association for the asset-based financing services industry. Its members include banks, commercial finance companies and other asset-based financiers.

Copyright Act did not operate to preempt the UCC for purposes of determining the rights of a secured party as against the rights of lien creditors (including bankruptcy trustees). Congress did not act on either FIPSA or the CFA proposal in 1999. Another CFA proposal, substantially similar to the first, was introduced in 2000, but Congress again declined to act on it. While isolated issues presented in this report might be redressed judicially over time, in cases such as the pending *Aerocon* appeal, ¹²⁴ a comprehensive resolution will require thoughtful, broad-based federal legislation.

V. Conclusion

There is substantial uncertainty in the law governing lending transactions secured with intellectual property rights or revenue streams derived from intellectual property. This confusion has resulted in significant additional expense and inconvenience for borrowing companies and their lenders. As more and more value in the American economy becomes attributable to intellectual property rights, the present legal morass will have an increasingly adverse impact on commercial lending transactions and the availability of business credit.

There is no inherent conflict in the *policies* underlying commercial law and intellectual property law, 125 yet recent court decisions have created conflicts which did not previously exist. Working capital financing transactions should be as cost-efficient as practicable for all parties. The legal rights of the parties should be predictable. Borrowers benefit when lenders are able to search applicable records and to perfect their security interests quickly and easily, and at low cost. It is these policy interests that Article 9 of the UCC was designed to serve, and which it has served effectively for nearly 40 years. The PTO and the Copyright Office are presently not equipped to accommodate the needs of borrowers and lenders in ordinary commercial finance transactions. Yet they are becoming increasingly deluged with registration and transfer requests relating to financial transactions. 126

The federal intellectual property laws are intended to define and protect ownership rights in qualified intellectual property. Accordingly, there is a strong federal interest in the maintenance of an efficient and predictable system for recording transfers of ownership rights in federally regulated intellectual property. Yet federal intellectual property law policy should not limit or hinder ordinary commercial lending transactions. The policies underlying commercial finance law and intellectual property law need not and should not compete with one another. To the extent that both federal and state laws facilitate a company's ability to borrow against the value of its intellectual property, those laws will further the development and use of intellectual property rights and therefore foster economic growth.

Lawmakers must balance these important policy interests and develop an integrated series of amendments to the federal intellectual property laws to resolve the problems addressed in this report. Any legislative solution must take into account the views of the wide spectrum of American businesses with valuable intellectual property rights, as well as the views of their lenders. An integrated solution would ease the burdens on the PTO and the Copyright Office and would restore cost-efficiency and predictability to the financing of intellectual property rights, for the mutual benefit of all parties and the economy as a whole.



¹²⁴ See supra part II.D.3(d).

¹²⁵ See Moldo v. Matsco (In re Cybernetic Services, Inc.), 239 B.R. 917, 922 (Bankr. 9th Cir. 1999), aff'd 252 F.3d 1039 (9th Cir. 2001); In re Transportation Design and Technology, 48 B.R. 635, 638 (Bankr. S.D. Cal. 1985).

¹²⁶ Jeffrey S. Turner, *Inventory and Accounts Financing of Manufacturers After Avalon and Quality King: Who Knew That Shampoo Was Intellectual Property?, Secured Lender* July-Aug. 1998, at 42.

CHAIRS AND VICE-CHAIRS BUSINESS LAW SECTION COMMITTEES 2000-2001

EXECUTIVE COMMITTEE

Twila L. Foster, Chair Crosby Heafey Roach & May

Paul J. Dubow, Vice-Chair Attorney at Law

Edith R. Warkentine, Vice-Chair *Professor,*Western State University, College of Law

Rhonda L. Nelson, Vice-Chair Severson & Werson

AGRIBUSINESS

Robert R. Neilson, Co-Chair *Tanimura & Antle, Inc.*

Clare M. Einsman, Co-Chair United Agribusiness League

Phillip H. Welch, Co-Vice Chair Lippenberger Thomapson et al

David E. Holland, Co-Vice Chair Baker Manock & Jensen

ALTERNATIVE DISPUTE RESOLUTION (ADR) Ad Hoc

Gerald F. Phillips, Chair Law Offices of Gerald F. Phillips CONSUMER FINANCIAL SERVICES

Robert K. Olsen, Chair Aldrich & Bonnefin, P.L.C.

Patricia Ann Cantu, Vice Chair Sanwa Bank of California

CORPORATE LAW DEPARTMENTS COMMITTEE

Kenneth J. Berke, Chair Davis Fox & Berke

Hugh A. O'Boyle, Co-Vice Chair *Homegain, Inc.*

Russell Boltwood, Co-Vice Chair *UT Starcom, Inc.*

CORPORATIONS COMMITTEE

Carol Lucas, Co-Chair Musick, Peeler & Garrett LLP

Robert Stansell, Co-Chair Procopio, Cory, Hargreaves & Savitch LLP

James R. Walther, Co-Vice Chair *Mayer, Brown & Platt*

Neil J. Wertlieb, Co-Vice Chair Milbank, Tweed, Hadley & McCloy LLP

Davis S. Caplan, Co-Vice Chair Brooks & Raub, APC

CYBERSPACE LAW COMMITTEE

Denis T. Rice, Chair Howard, Rice, Nemerovski, Canady, Falk & Rabkin

> William Tolin Gay, Vice Chair Snell & Wilmer LLP

EDUCATION COMMITTEE

Jennifer Suzuki, Co-Chair Long & Levit LLP

Elaine F. B. Leadlove, Co-Chair *Attorney at Law*

FINANCIAL INSTITUTIONS COMMITTEE

Maureen A. Young, Chair Senior Counsel, Bank of America

Mark A. Moore, Vice-Chair *Aldrich & Bonnefin*

FRANCHISE LAW COMMITTEE

Joel D. Siegel, Co-Chair Jenkins, Gilchrist, Solish, Arbiter & Gehrig

Charles G. Miller, Co-Vice Chair Bartko, Zankel, Tarrant & Miller Rochelle B. Spandorf, Co-Vice Chair Sonnenshein, Nath & Rosenthal

INSOLVENCY LAW COMMITTEE

Jennifer C. Hagle, Chair Sidley & Austin

Rebecca Callahan, Vice Chair Law Offices of Rebecca Callahan P.C.

INSURANCE LAW COMMITTEE

Patrick J. McDonough, Chair Troop, Steuber, Pasich, Reddick, Tobey LLP

> Marvin Mohn, Vice Chair Price Waterhouse Coopers

NON-PROFIT ORGANIZATIONS COMMITTEE

Jeffrey M. Ogata, Co-Chair California Energy Commission

Loius E. Michelson, Co-Chair Law Offices of Louis E. Michelson

John W. Francis, Legislative Chair Attorney at Law

PARTNERSHIPS AND LLC'S COMMITTEE

Steven T. Anapoell, Chair Pillsbury, Madison & Sutro LLP

Benjamin J. Westreich, Vice-Chair *Katten, Muchin & Cavis*

UCC COMMITTEE

Jeffrey L. Schaffer, Chair Howard Rice Nemerovski Canady Falk & Rabkin

Paul J. Pascuzzi, Co-Vice Chair Felderstein Willoughby & Pascuzzi LLP

Anthony R. Callobre, Co-Vice Chair Sheppard Mullin Richter & Hampton LLP